ECONOMICS OF DEFENSE POLICY: ADM. H. G. RICKOVER

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SEVENTH CONGRESS

SECOND SESSION

PART 3

NAVY CONTRACTS AND GOVERNMENT POLICIES

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE
92-530 O WASHINGTON : 1982

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

J841-33

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

HOUSE OF REPRESENTATIVES

HENRY S. REUSS, Wisconsin, *Chairman*
RICHARD BOLLING, Missouri
LEE H. HAMILTON, Indiana
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
FREDERICK W. RICHMOND, New York
CLARENCE J. BROWN, Ohio
MARGARET M. HECKLER, Massachusetts
JOHN H. ROUSSELOT, California
CHALMERS P. WYLIE, Ohio

SENATE

ROGER W. JEPSEN, Iowa, *Vice Chairman*
WILLIAM V. ROTH, Jr., Delaware
JAMES ABDNOR, South Dakota
STEVEN D. SYMMS, Idaho
PAULA HAWKINS, Florida
MACK MATTINGLY, Georgia
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

JAMES K. GALBRAITH, *Executive Director*
BRUCE R. BARTLETT, *Deputy Director*

CONTENTS

NAVY CONTRACTS AND GOVERNMENT POLICIES

Page

August 23, 1968—H. G. Rickover memorandum for the Chief of Naval Material responding to Chief of Naval Material memorandum of August 22, 1968, and recommending the contract fee which the Naval Material Command considered too low be increased by 5 cents ---------------- 1

August 26, 1968—Chief of Naval Material memorandum responding to H. G. Rickover memorandum of August 23, 1968, stating the August 22, 1968, Chief of Naval Material memorandum on this issue was misinterpreted, and directing that the contract postnegotiation clearance logically justify the fee negotiated ---------------------------------- 2

September 11, 1968—H. G. Rickover memorandum for the Chief of Naval Material taking exception to the contention of the August 16, 1968, Chief of Naval Material memorandum that the August 22, 1968, Chief of Naval Material memorandum was misinterpreted ------------------- 3

September 26, 1968—Chief of Naval Material memorandum responding to H. G. Rickover memorandum of September 11, 1968, and stating that "in our acquisition process there is required a mutual exchange of information, such that our recent exchange of correspondence would be unnecessary" -- 5

October 16, 1968—H. G. Rickover memorandum responding to the Chief of Naval Material's September 26, 1968, memorandum and emphasizing that the Naval Material Command should not be directing the Naval Ship Systems Command to pay higher fees. (No record exists of a response to this memorandum.) ------------------------------------ 6

November 13, 1968—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning the need for improvements in ship procurement practices ----------------------- 7

November 20 and November 25, 1968—Assistant Secretary of the Navy memoranda responding to H. G. Rickover's November 13, 1968, memorandum on the need for improvements in ship procurement practices and stating these issues are being addressed by a Pricing and Cost Control Study Group -- 11-12

February 12, 1969—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning the procurement of main sea water pumps for SSN 685 as an example of the need for improvements in ship procurement practices ----------------------- 13

March 17, 1969—Assistant Secretary of the Navy (Installations and Logistics) memorandum responding to H. G. Rickover's February 12, 1969, memorandum on the procurement of main sea water pumps for SSN 685 as an example of the need for improvements in ship procurement practices. The response states the Pricing and Cost Control Study Group is addressing the problem ------------------------- 15

March 28, 1969—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning the procurement of main sea water pumps for SSN 685 ------------------------- 16

May 7, 1969—Chief of Naval Material memorandum for H. G. Rickover describing the resolution of the problem set forth in H. G. Rickover's March 28, 1969, memorandum for the Assistant Secretary of the Navy (Installations and Logistics) on the procurement of the main sea water pumps for SSN 685 -- 18

Page

April 30, 1969—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning review of controls over construction costs of nuclear-powered ships at Newport News Shipbuilding & Dry Dock Co. (See response to October 23, 1969, H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics).) ---------- 19

July 8, 1969—H. G. Rickover memorandum for the Chief of Naval Material stating that actions by the Naval Material Command Procurement and Control Division are having a deleterious impact on the naval nuclear propulsion program. (No record exists of a response to this memorandum.) ---------- 23

July 15, 1969—H. G. Rickover letter concerning the contractual status of technical correspondence and documents exchanged between shipbuilders and the Government regarding work under the technical cognizance of NAVSHIPS (08) in ships under construction ---------- 28

July 25, 1969—Newport News president's letter to H. G. Rickover agreeing to implement the actions of H. G. Rickover's letter of July 15, 1969, on the contractual status of technical correspondence and documents exchanged between shipbuilders and the Government regarding work under the technical cognizance of NAVSHIPS (08) in ships under construction ---------- 31

August 20, 1969—Electric Boat general manager letter to the Commander, Naval Ship Systems Command, agreeing to implement the actions of H. G. Rickover's July 15, 1969, letter on the contractual status of technical correspondence and documents exchanged between shipbuilders and the Government regarding work under the technical cognizance of NAVSHIPS (08) in ships under construction ---------- 32

September 13, 1969—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning procurement practices and cost control under Navy contracts with Electric Boat Division, General Dynmaics. (No record exists of a response to this memorandum.) ---------- 33

October 23, 1969—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning the need for improved procurement and cost control practices in the construction of Naval ships- 76

December 1, 1969—Commander, Naval Ship Systems Command memorandum responding to and enclosing the action taken on H. G. Rickover's memoranda of April 30, 1969, and October 23, 1969, concerning control of construction costs at Newport News Shipbuilding & Dry Dock Co- 78

December 23, 1969—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning deficiencies in the procurement of hull steel by Newport News Shipbuilding & Dry Dock Co- 84

January 7, 1979—Commander, Naval Ship Systems Command memorandum for the Deputy Commander for Nuclear Propulsion responding to and indicating the actions taken on H. G. Rickover's December 23, 1969, memorandum concerning deficiencies in procurement of hull steel by Newport News Shipbuilding ---------- 91

January 29, 1970—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning deficiencies in procurement of hull steel by Newport News Shipbuilding & Dry Dock Co ---------- 94

March 5, 1970—Deputy Commander, Naval Ship Systems Command (Field Activities) memorandum to the Chief of Naval Material (MAT 021) concerning H. G. Rickover's memoranda of December 23, 1969, and January 29, 1969, concerning deficiencies in procurement of hull steel by Newport News ---------- 97

February 2, 1970—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command recommending corrective action for the unsatisfactory situation with shipbuilding and overhaul contracts at Ingalls Shipbuilding. (No record of a response to this memorandum.) ---- 100

February 14, 1970—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command requesting corrective action regarding the unsatisfactory situation with shipbuilding and overhaul contracts at Newport News and Electric Boat ---------- 103

March 9, 1970—Commander, Naval Ship Systems Command memorandum responding to H. G. Rickover's February 14, 1970, memorandum concerning the unsatisfactory situation with shipbuilding and overhaul contracts at Electric Boat and Newport News. The response states that some of the problems which led to the situation have been resolved and "we are looking toward a solution (to the others) as soon as possible" ---------- 107

Page

February 16, 1970—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning control of ship construction costs at Newport News Shipbuilding & Dry Dock Co. (No record exists of a response to this memorandum.) 110

February 19, 1970—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning procurement practices and cost control under Navy contracts at Electric Boat Division, General Dynamics. (No record exists of a response to this memorandum.) 120

March 25, 1970—H. G. Rickover letter to Senator William Proxmire concerning remarks by Gordon W. Rule on the naval nuclear propulsion program in testimony before the Joint Economic Committee 144

May 28, 1970—H. G. Rickover letter to Senator William Proxmire concerning implementation of the Truth-In-Negotiations Act by the Department of Defense 150

July 15, 1970—H. G. Rickover memoradum for the Assistant Secretary of the Navy (Installations and Logistics) concerning overhead costs on Navy contracts at Electric Boat. (Enclosures deleted.) (No record exists of a response to this memoradum.) 157

August 26, 1970—H. G. Rickover memorandum for Assistant Secretary of the Navy (Installations and Logistics) commenting on NAVSHIPS investigation of deficiencies in procurement and cost control practices of the Electric Boat Division, General Dynamics 160

September 17, 1970—Assistant Secretary of the Navy (Installations and Logistics) memorandum responding to H. G. Rickover's August 26, 1970, memorandum on NAVSHIPS investigation of deficiencies in procurement and cost control practices at Electric Boat. The response states that H. G. Rickover's comments are being forwarded to the Naval Material Command for comment and action 212

October 13, 1970—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning lack of corrective action on procurement and cost control deficiencies at Newport News Shipbuilding & Dry Dock Co. (No record exists of a response to this memorandum.) 213

October 30, 1970—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning excessive shipbuilder profits on nuclear submarine overhaul and conversion contracts 215

November 20, 1970—Assistant Secretary of the Navy (Installations and Logistics) memorandum for the Chief of Naval Material concerning H. G. Rickover's October 30, 1970, memorandum on excessive shipbuilder profits on nuclear submarine and overhaul contracts. The Assistant Secretary recommends certain actions be taken immediately on this matter 220

December 2, 1970—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Financial Management) concerning contractor cost performance measurement for commercial shipbuilders. (No record exists of a response to this memorandum.) 222

February 4, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning cost control and procurement deficiencies at Electric Boat Division of General Dynamics and Newport News Shipbuilding & Dry Dock Co. (No record exists of a response to this memorandum.) 225

April 14, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning deficiencies in the procurement of nickel alloy materials by Newport News Shipbuilding & Dry Dock Co. 227

June 7, 1971—Commander, Naval Ship Systems Command memorandum responding to April 14, 1971, H. G. Rickover memorandum on deficiencies in procurement of nickel alloy materials by Newport News and forwarding a report of actions taken by the supervisor of shipbuilding, Newport News on the issue 236

May 6, 1971—H. G. Rickover memorandum for the Deputy Chief of Naval Material (Procurement and Production) concerning excessive profit rates on Navy contracts with Electric Boat for SSBN Poseidon missile conversions. (No record exists of a response to this memorandum.) 240

June 4, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning the need for improved controls over change order pricing at Electric Boat. (No record exists of a response to this memorandum.) 243

Page

July 14, 1971—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning excessive progress payments on nuclear shipbuilding contracts at Newport News Shipbuilding & Dry Dock Co. (See response to October 2, 1971, H. G. Rickover memorandum for Assistant Secretary of the Navy (Installations and Logistics).) 248

September 11, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning employment of Electric Boat personnel by the supervisor of shipbuilding, Groton, Conn 252

January 17, 1972—Commander, Naval Ship Systems Command memorandum disagreeing with H. G. Rickover's September 11, 1971, memorandum concerning employment of Electric Boat personnel by the supervisor of shipbuilding, Groton, Conn 254

September 15, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning the recurring deficiencies in Newport News Shipbuilding & Dry Dock Co.'s procurement procedures. (Enclosures deleted.) (No record exists of a response to this memorandum.) 255

September 18, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning excessive costs of nuclear submarine overhaul and conversion contracts at Electric Boat 258

April 6, 1972—Commander, Naval Ship Systems Command memorandum reporting actions taken in response to H. G. Rickover's September 18, 1971, memorandum on the excessive costs of nuclear submarine overhaul contracts at Electric Boat 263

October 2, 1971—H. G. Rickover memorandum for Assistant Secretary of the Navy (Installations and Logistics) concerning progress payments on nuclear shipbuilding contracts 264

October 26, 1971—Assistant Secretary of the Navy (Installations and Logistics) memorandum responding to H. G. Rickover's October 2, 1971, and July 14, 1971, memoranda concerning progress payments on nuclear shipbuilding contracts. The response requests, by copy, that the Chief of Naval Material promptly implement the recommendations of the H. G. Rickover memoranda 266

October 13, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning the need for improved controls over change order pricing at Electric Boat. (No record exists of a response to this memorandum.) 268

November 15, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning the need for improved controls over change order pricing at Electric Boat. (No record exists of a response to this memorandum.) 269

December 14, 1971—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command recommending a reduction in the use of overtime on contracts for overhaul or conversion of commissioned nuclear submarines in private shipyards. (No record exists of a response to this memorandum.) 271

December 20, 1971—H. G. Rickover memorandum concerning the contractual impact of technical documents and design data furnished to shipbuilders by reactor plant prime contracts and reactor plant lead yards for ships under construction 272

January 17, 1972—Newport News Shipbuilding & Dry Dock Co. letter to Supervisor of Shipbuilding, Newport News, agreeing to implement the actions of H. G. Rickover's December 20, 1971, memorandum concerning the contractual impact of technical documents and design data furnished to shipbuilders by reactor plant prime contractors and reactor plant lead yards for ships under construction 274

February 2, 1972—Electric Boat general manager letter agreeing to implement the actions of H.G. Rickover's December 20, 1971, memorandum concerning the contractual impact of technical documents and design data furnished to shipbuilders by reactor plant prime contractors and reactor plant lead yards for ships under construction 275

December 28, 1971—H. G. Rickover memorandum for the Chief of Naval Material concerning Litton Industries management of Navy shipbuilding work at the Ingalls Nuclear Shipbuilding Division (East Bank) and Ship Systems Division (West Bank) Pascagoula, Miss. (No record exists of a response to this memorandum.) 276

Page

January 19, 1972—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning review of procurement and cost control systems at Electric Boat. (No record exists of a response to this memorandum.) ---- 278

February 7, 1972—H. G. Rickover letter to Senator Proxmire concerning costs incurred and profits paid on nuclear submarine overhauls at two major shipyards ---- 293

February 22, 1972—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning employment of former shipbuilder personnel by supervisors of shipbuilding to monitor contractor performance of shipbuilding contracts. (No record exists of a response to this memorandum.) ---- 305

February 28, 1972—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning progress payments on nuclear shipbuilding contracts ---- 307

March 23, 1972—Assistant Secretary of the Navy (Installations and Logistics) memorandum responding to and reporting the actions taken on H. G. Rickover's February 28, 1972, memorandum concerning progress payments on nuclear shipbuilding contracts ---- 310

March 27, 1972—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning progress payments on Navy Shipbuilding contracts ---- 312

April 21, 1972—Assistant Secretary of the Navy (Installations and Logistics) memorandum responding to H. G. Rickover's March 27, 1972, memorandum on progress payments on Navy shipbuilding contracts. The response indicates that, contrary to H. G. Rickover's recommendation, existing Navy policy is adequate to improve the situation ---- 315

March 27, 1972—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning overtime and productivity in shipyards. (No record exists of a response to this memorandum.) ---- 316

March 27, 1972—H. G. Rickover letter to the president of Newport News Shipbuilding & Dry Dock Co. concerning a speech by the Newport News vice president for contracts. The speech described contractor abuses on defense contracts as myths ---- 329

April 26, 1972—Newport News president letter responding to H. G. Rickover's March 27, 1972, letter concerning a speech by the Newport News vice president for contracts. The response states that Newport News will establish a review procedure for future speeches which deal with the company's relationships with its principal customers ---- 331

March 31, 1972—H. G. Rickover letter to the Director, Defense Contract Audit Agency (DCAA) recommending areas where DCAA can make substantial improvements in its audit coverage ---- 332

April 7, 1972—Defense Contract Audit Agency (DCAA) Director letter responding favorably to H. G. Rickover's March 31, 1972, letter recommending areas where DCAA can improve its audit coverage ---- 338

April 28, 1972—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning progress payments under Navy shipbuilding contracts and raising matters to the Assistant Secretary which warrant his personal attention. (No response to this memorandum was received.) ---- 340

July 18, 1972—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning excessive prices for changes to NAVSHIPS contracts at Ingalls Shipbuilding. (No record exists of a response to this memorandum.) ---- 348

July 18, 1972—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning excessive progress payments on the contract for construction of SSN's 680, 682, and 683 at Ingalls Shipbuilding ---- 362

August 11, 1972—Commander, Naval Ship Systems Command memorandum responding to H. G. Rickover's July 18, 1972, memorandum concerning excessive progress payments on the contract for construction of SSN's 680, 682, and 683 at Ingalls Shipbuilding and stating the overpayment will be corrected with the next payment ---- 364

October 24, 1972—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning progress payments on the contract for construction of SSN's 680, 682, and 683 at Ingalls Shipbuilding. (No record exists of a response to this memorandum.) ---- 370

Page

December 11, 1972—H. G. Rickover memorandum for the Chief of Naval Material regarding proposed contract clauses for change orders being considered for incorporation into the Armed Services Procurement Regulation. (No record exists of a response to this memorandum.) 372

February 13, 1973—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning excessive progress payments on the contract for construction of SSN's 680, 682, and 683 at Ingalls Shipbuilding 382

March 14, 1973—Vice Commander, Naval Ship Systems Command memorandum reporting on the actions taken with regard to H. G. Rickover's February 13, 1973, memorandum concerning excessive progress payments on the contract for construction of SSN's 680, 682, and 683 at Ingalls Shipbuilding 390

March 13, 1973—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command requesting what action is being taken with regard to excessive prices for changes to NAVSHIPS contracts at Ingalls Shipbuilding. (No record exists of a response to this memorandum.) 391

May 26, 1973—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning excessive progress payments on the contract for construction of SSN's 680, 682, and 683 at Ingalls Shipbuilding. (No record exists of a response to this memorandum.) 392

July 9, 1973—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning formal meetings between Ingalls Shipbuilding and the supervisor of shipbuilding, Pascagoula on financial, contractual and management matters. (No record exists of a response to this memorandum.) 401

August 20, 1973—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning industry compliance with the requirements of the Truth-In-Negotiations Act. (No record exists of a response to this memorandum.) 404

September 5, 1973—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) concerning cost control at Newport News Shipbuilding & Dry Dock Co. (No record exists of a response to this memorandum.) 417

March 28, 1974—H. G. Rickover memorandum for the Chief of Naval Operations concerning interpretation of the Defense Production Act for purposes of determining eligibility of the construction of certain types of commercial vessels for defense priorities. (No record exists of a response to this memorandum.) 427

April 11, 1974—H. G. Rickover memorandum to the Commander, Naval Ship Systems Command concerning deficiencies in procurement of material by private shipyards. (No record exists of a response to this memorandum.) 431

June 17, 1974—H. G. Rickover memorandum for the Commander, Naval Ship Systems Command concerning the Department of Defense's contractor cost data reporting system. (No record exists of a response to this memorandum.) 434

June 19, 1975—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) requesting assistance in obtaining supplier acceptance of urgent defense orders containing cost accounting standards requirements. (No record exists of a response to this memorandum.) 436

July 10, 1975—H. G. Rickover memorandum for the Assistant Secretary of the Navy (Installations and Logistics) requesting assistance in obtaining supplier acceptance of urgent defense orders containing cost accounting standards requirements. (No record exists of a response to this memorandum.) 438

August 17, 1976—H. G. Rickover memorandum for the Chief of Naval Material recommending action to obtain priority assistance from the Department of Commerce to insure Newport News does not allow Navy work to be delayed by commercial work. (No record exists of a response to this memorandum.) 440

November 10, 1976—H. G. Rickover letter to the President of Newport News Shipbuilding & Dry Dock Co. requesting compliance with the company's 1969 agreement to identify the contractual status of actions recommended in the company's technical submittals 442

November 29, 1976—Newport News Shipbuilding President's letter refusing to comply with the request of H. G. Rickover's November 10, 1976, letter that Newport News comply with the company's 1969 agreement to identify the contractual status of actions recommended in the company's technical submittals .... Page 451

January 12, 1978—H. G. Rickover memorandum for the Deputy Secretary of Defense (enclosure deleted) comparing Newport News and Electric Boat costs to build SSN 688 class submarines. (No response to this memorandum was received.) 452

April 5, 1978—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning the procurement of fiscal year 1978–79 SSN 688 class submarines 459

April 5, 1978—Commander, Naval Sea Systems Command memorandum responding to and agreeing with H. G. Rickover's April 5, 1978, memorandum concerning the procurement of fiscal year 1978–79 SSN 688 Class submarines 461

September 8, 1978—H. G. Rickover memorandum for the Secretary of the Navy reporting that day-to-day contractual problems at Electric Boat are growing worse. (No response to this memorandum was received.) 462

September 20, 1978—H. G. Rickover memorandum for the Secretary of the Navy providing further information about contractual problems at Electric Boat. (No response to this memorandum was received.) 467

October 2, 1978—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command raising issues which need to be resolved and commitments to be obtained from General Dynamics management in a forthcoming meeting between Navy and General Dynamics officials. (No response to this memorandum was received.) 473

October 3, 1978—H. G. Rickover memorandum for the Secretary of the Navy concerning a meeting to be held between the Secretary and General Dynamics officials. (No response to this memorandum was received.) 483

April 13, 1979—H. G. Rickover memorandum for the Secretary of the Navy recommending allocation of two fiscal year 1980–81 SSN 688 class ships to Newport News in conjunction with the award of the two fiscal year 1978–79 SSN 688 class ships to Electric Boat because of the likely "buy-in" by Electric Boat. (No response to this memorandum was received.) 485

January 11, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning adjudication of delays in Ingalls submarine overhaul work 490

January 29, 1980—Commander, Naval Sea Systems Command memorandum responding to and concurring with H. G. Rickover's January 11, 1980, memorandum concerning the adjudication of delays in Ingalls submarine overhaul work 493

February 6, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command commenting on a proposed NAVSEA position regarding the "Naval Ship Procurement Process Study" recommendation to expedite the settling of shipbuilding contract changes through various techniques for pricing delay and disruption; the memorandum recommends against such techniques 494

February 27, 1980—Commander, Naval Sea Systems Command memorandum responding to H. G. Rickover's February 6, 1980, memorandum concerning a proposed NAVSEA position regarding the "Naval Ship Procurement Process Study" recommendation to expedite the settling of shipbuilding contract changes through various techniques for pricing delay and disruption. The response agrees to revise the NAVSEA position along the lines of the Rickover memorandum 500

March 31, 1980—H. G. Rickover letter to the chairman of the board, General Dynamics Corp., raising the Electric Boat general manager's refusal to hold weekly meetings with submarine commanding officers and to submit critical items reports. (No record exists of a response to this letter.) 502

June 24, 1980—H. G. Rickover memorandum for the Secretary of the Navy discussing contractual problems with nuclear submarine work at theElectric Boat Division of General Dynamics Corp. (No response to this memorandum was received.) 504

Page

July 15, 1980—H. G. Rickover memorandum for the Secretary of the Navy concerning the cancellation of plans to accomplish reactor modifications in *Arkansas* (CGN 41) because of the insistence of Newport News to claim contract adjustments on other contracts for accomplishing the modification. (No response to this memorandum was received.) ... 510

July 15, 1980—H. G. Rickover memorandum for the Secretary of the Navy discussing the adverse impact on nuclear submarine manning resulting from delays in nuclear submarine work at Electric Boat. (No response to this memorandum was received.) ... 514

July 25, 1980—H. G. Rickover memorandum for the supervisor of shipbuilding, Newport News, concerning the use of unilateral change orders. (No response to this memorandum was received.) ... 517

August 27, 1980—H. G. Rickover memorandum for the General Counsel of the Navy and the Comptroller of the Navy concerning the deferred payment agreements with Electric Boat Division in connection with the Armed Services Board of Contract Appeals case regarding cost disallowance under "Basic Agreement Concerning Overhead Costs." (See October 23, 1980, H. G. Rickover memorandum for the General Counsel of the Navy and the Comptroller of the Navy for the response to this August 27, 1980 memorandum.) ... 519

September 6, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning Electric Boat's refusal to honor its agreement with the Navy for repairs of Government furnished equipment ... 522

September 11, 1980—Commander Naval Sea Systems Command memorandum responding to H. G. Rickover's September 6, 1980, memorandum concerning Electric Boat's refusal to honor its agreement with the Navy for repairs of Government furnished equipment. The response states that the issue will be taken up in Trident and SSN 688 class negotiations ... 534

September 24, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning Government furnished equipment repairs at Electric Boat. (No record exists of a response to this memorandum.) ... 535

September 24, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command recommending the fiscal year 1981 nuclear submarines be excluded from the Navy's request for a Presidential determination to build warships in private shipyards ... 537

January 8, 1981—Commander, Naval Sea Systems Command memorandum responding to H. G. Rickover's September 24, 1981, memorandum recommending the fiscal year 1981 nuclear submarines be excluded from the Navy's request for a Presidential determination to build warships in private shipyards. The response states this recommendation should not be adopted for fiscal year 1981 submarines, but could be pursued in later years ... 539

October 15, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command recommending neither the Quincy Shipbuilding Division nor the Electric Boat Division of General Dynamics be assigned nuclear submarine repair or overhaul work. (No response to this memorandum was received.) ... 540

October 22, 1980—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning Electric Boat's proposals for accomplishing revisions to Trident ship construction drawings. (No response to this memorandum was received.) ... 545

October 23, 1980—H. G. Rickover memorandum for the General Counsel of the Navy and the Comptroller of the Navy concering the deferred payment agreements with Electric Boat Division in connection with the Armed Services Board of Contract Appeals case regarding cost disallowance under the "Basic Agreement Concerning Overhead Costs" ... 549

November 4, 1980—General Counsel of the Navy memorandum responding to H. G. Rickover's August 27, 1980, and October 23, 1981 memoranda concerning the deferred payment agreements with Electric Boat Division in connection with the Armed Services Board of Contract Appeals case regarding cost disallowance under the "Basic Agreement Concerning Overhead Costs." The response states that the H. G. Rickover recommendations have been forwarded to the Navy Office of General Counsel Litigation Division ... 551

Page

November 21, 1980—H. G. Rickover memorandum for the Chief of Naval Operations recommending against Navy issuance or endorsement of a Center for Naval Analyses study on the disruption costs in Navy shipbuilding programs 552

January 2, 1981—Chief of Naval Operations memorandum responding to and agreeing with H. G. Rickover's November 21, 1981, memorandum recommending against Navy issuance or endorsement of a Center for Naval Analyses study on the disruption costs in Navy shipbuilding programs 556

December 11, 1980—H. G. Rickover memorandum for the Secretary of the Navy concerning General Dynamics (Electric Boat Division) delay to resolution of the Armed Services Board of Contract Appeals case regarding disallowed overhead costs under the "Basic Agreement Concerning Overhead Costs." (No response to this memorandum was received.) 557

December 13, 1980—H. G. Rickover memorandum for the Secretary of the Navy requesting a response to recommendations submitted regarding problems relating to Naval ship construction. (No response to this memorandum was received.) 560

December 24, 1980—H. G. Rickover memorandum for the Deputy Secretary of Defense requesting assistance in obtaining answers to recommendations for improvement in Government operations 561

January 16, 1981—Deputy Secretary of Defense memorandum responding to H. G. Rickover's December 24, 1980, memorandum requesting assistance in obtaining answers to recommendations for improvement in Government operations. The Deputy Secretary states he has forwarded the H. G. Rickover memoranda to his successor with his recommendations on them 563

December 29, 1980—H. G. Rickover memorandum for the Secretary of the Navy concerning newspaper accounts of the Secretary of the Navy stating that Admiral Rickover sought to hamper construction of the Trident submarine by trying to create ill will between the Navy and the shipbuilder. (No response to this memorandum was received.) 564

January 8, 1981—H. G. Rickover letter to Congressman Charles E. Bennett concerning the Secretary of the Navy charging that Admiral Rickover sought to hamper construction of the Trident submarine 567

January 16, 1981—H. G. Rickover memorandum for the Chief of Naval Material recommending modification of the Navy Procurement Directives to require use of the NAVSEA Notification of Changes clause in all future shipbuilding contracts 569

January 22, 1981—Chief of Naval Material memorandum disagreeing with H. G. Rickover's January 16, 1981, memorandum recommending modification of the Navy procurement directives to require use of the NAVSEA notification of changes clause in all future shipbuilding contracts 571

January 23, 1981—H. G. Rickover memorandum for the Chief of Naval Operations recommending the Navy preclude the Center for Naval Analyses from issuing a study on disruption costs in Navy shipbuilding programs 572

February 14, 1981—Chief of Naval Operations memorandum disagreeing with the recommendation of the January 23, 1981, H. G. Rickover memorandum that the Navy preclude the Center for Naval Analyses from issuing a study on disruption costs in Navy shipbuilding programs 574

February 17, 1981—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command recommending steps to limit ceremonial expenses in Naval ship construction at private yards 575

March 19, 1981—Commander, Naval Sea Systems Command memorandum addressing ceremonial expenses in Naval ship construction at private yards 577

March 2, 1981—H. G. Rickover memorandum for the Chief of Naval Material concerning a Newport News proposal for the inspection of a valve in ATLANTA (SSN 712). (No response to this memorandum was received.) 578

October 29, 1981—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning the proposed incentives for early delivery of CVN 71. (No response to this memorandum was received.) 580

	Page
December 3, 1981—H. G. Rickover memorandum for the Assistant Secretary of the Navy, Shipbuilding and Logistics, recommending a Center for Naval Analyses study entitled "Disruption Costs in Navy Shipbuilding Programs" not be approved by the Navy for release	582
December 4, 1981—Assistant Secretary of the Navy (Shipbuilding and Logistics) memorandum for the Chief of Naval Material agreeing with H. G. Rickover's December 3, 1981, memorandum about the Center for Naval Analyses study on disruption costs in Navy shipbuilding programs	589
January 7, 1982—H. G. Rickover memorandum for the Commander, Naval Sea Systems Command concerning contractual arrangements for the Post Shakedown Availability of the USS OHIO (SSBN 726). (No response to this memorandum was received.)	590

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO

August 23, 1968

MEMORANDUM FOR CHIEF OF NAVAL MATERIAL

Subj: Chief Of Naval Material Requirement That NAVSHIPS Pay Higher Fee On Proposed Contract With Westinghouse Electric Corporation

Ref: (a) Naval Material letter MAT 022/CHR; Ser: 03195 dated 22 August 1968

1. Reference (a) returned a Naval Ship Systems Command (NAVSHIPS) request for Chief of Naval Material (CNM) approval of a pre-negotiation business clearance for a contract with Westinghouse Electric Corporation involving the procurement of reactor components for nuclear ships. The contract is estimated to cost $50,808,394 for which NAVSHIPS proposed to pay a fixed fee of $1,147,023 (2.29%). Reference (a) disapproved the fixed fee of 2.29% as being too low.

2. I am at a loss to understand the rationale of reference (a) which would require NAVSHIPS to pay a higher fixed fee. It has been my understanding that Government officials are obligated to obtain services at the lowest possible cost. For many years I have been exhorted to do so by innumerable documents issued by the President of the United States, the Director of the Bureau of the Budget, the Secretary of Defense, the Secretary of the Navy, the Chief of Naval Material, and the Commander of Naval Ship Systems Command. I have been able to obtain these very same services from Westinghouse and from General Electric for many years at the 2.29% or a lower fixed fee.

3. Reference (a) states that CNM cannot agree that the contractor's risk in this procurement is zero, but no reason is given to show that there is any risk. I hereby reaffirm that the contractor's risk is and always has been zero—period.

4. In order not to delay award of this contract, I will comply with your requirement that a higher fixed fee be paid. I am therefore recommending to NAVSHIPS Division of Contracts that the fixed fee on this $50,808,394 contract be increased from $1,147,023 to $1,147,023.05 or from 2.29% to 2.29000001%.

5. In view of my compliance with your request I consider this matter to be closed.

H. G. Rickover
H. G. Rickover

Copy to:
Assistant Secretary of the Navy (Installations and Logistics)
Commander, Naval Ship Systems Command
NAVSHIPS Division of Contracts

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

26 AUG 1968

MEMORANDUM FOR VICE ADMIRAL H. G. RICKOVER (NAVSHIP-08)

Subj: Pre-Negotiation Business Clearance SS 12,918, Westinghouse Electric Corporation

Ref: (a) CNM ltr MAT 022/GWR Ser: 03195 of 22 Aug 1968 to NAVSHIPS
(b) NAVSHIPS Memo for CNM of Aug 23, 1968

1. Reference (b) has misinterpreted reference (a). No direction was provided to increase the fee under subject contract. The rationale presented in subject pre-negotiation clearance was insufficient as well as inconsistent to justify the negotiation position in accordance with the weighted guidelines set forth in ASPR, Section 3-808.3. Review with members of the negotiation team failed to elicit further information.

2. The action proposed in paragraph 4 of reference (b) is disapproved and by copy of this memorandum the Commander, Naval Ship Systems Command is requested to provide in the post negotiation clearance sufficient information to logically justify the fee negotiated.

I. J. GALANTIN
Admiral, USN
Chief of Naval Material

Copy to:
NAVSHIPSYSCOM
ASN(I&L)

08H-351

11 SEP 1968

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: NAVSHIPS contract N00024-69-C-5101 with Westinghouse Electric
Corporation for nuclear propulsion plant components

Ref: (a) NAVMAT memorandum Ser 03195 dtd 22 August 1968
(b) VADM H. G. Rickover memorandum to the Chief of Naval
Material dtd 23 August 1968
(c) Chief of Naval Material memorandum for VADM H. G. Rickover
dtd 26 August 1968

1. In reference (a), the Naval Material Command (NAVMAT) disapproved a Naval Ship Systems Command (NAVSHIPS) pre-negotiation business clearance to contract for nuclear propulsion plant components. The contract was estimated to cost $50,088,394 for which NAVSHIPS proposed to pay a fixed fee of $1,147,023 (2.29%). NAVMAT approved the NAVSHIPS pre-negotiation position on costs, but disapproved the proposed fixed fee of 2.29%, stating that "a higher fee is authorized".

2. In reference (b), I informed you of my recommendation to the NAVSHIPS Division of Contracts that the fixed fee on this $50,088,394 contract be increased from $1,147,023 to $1,147,023.05, or from 2.29% to 2.2900001%, thereby complying with the NAVMAT directive that a higher fixed fee be paid.

3. Reference (c) stated that I had "misinterpreted" the August 23 NAVMAT memorandum, reference (a), and that:

> "No direction was provided to increase the fee under the subject contract. The rationale presented in subject pre-negotiation clearance was insufficient as well as inconsistent to justify the negotiation position in accordance with the weighted guidelines set forth in ASPR, Section 3-808.3. Review with members of the negotiation team failed to elicit further information."
>
> ". . . the Commander, Naval Ship Systems Command is requested to provide in the post negotiation clearance sufficient information to logically justify the fee negotiated."

4. Subsequent to the above memorandum, NAVMAT approved the award of this contract at the fixed fee originally recommended by NAVSHIPS, namely, 2.29%, thereby negating the NAVMAT directives in reference (a) and (c). The contract has now been awarded to and accepted by Westinghouse.

5. I would like to make two points relative to award of this contract:

a. I consider that reference (a) was quite clear in requesting that NAVSHIPS pay a higher fee on this contract. Reference (a) stated:

> "Paragraph 7 of subject clearance states that all of the components are subcontracted and are the responsibility of the prime contractor, a responsibility that will continue for over five years. This office cannot agree that this responsibility is worth only a 1.75% assigned weight as shown above, with a zero assigned weight for contractor's risk below the line. Nor has it been shown that the contractor's request for a 5% fixed fee is an unreasonable one."
>
> "Enclosure (1) is returned approved with respect to the prenegotiation position on costs but disapproved with respect to a fixed fee of 2.29%. A higher fee is authorized."

b. In reference (c) you stated that the NAVSHIP'S rationale for a 2.29% was "insufficient as well as inconsistent to justify the negotiation position in accordance with the weighted guidelines set forth in ASPR, Section 3-803". Please note that NAVMAT has reviewed and approved prime contracts for nuclear component work at levels of 2.29% or less for the past several years.

6. In sum, NAVMAT'S contribution to the negotiation and award of this contract was:

a. A directive that NAVSHIPS pay a higher fixed fee than NAVSHIPS considered appropriate, and higher than the supplier was willing to accept.

b. A recision of that directive.

c. A delay of 20 days in obtaining a contract.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Assistant Secretary of the Navy (Installations and Logistics)
Commander, Naval Ship Systems Command
Division of Contracts, NAVSHIPS

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO

26 SEP 1968

MEMORANDUM FOR VICE ADMIRAL H. G. RICKOVER (NAVSHIPS-08)

Subj: Westinghouse Electric Corporation Procurement for Nuclear Reactor Components

1. I have reviewed your letter of 11 September 1968. I believe it appropriate to indicate that the material provided my staff on 27 August 1968 regarding the Westinghouse contract should have been set forth in the pre-negotiation clearance submitted by NAVSHIPS. In addition, if the "weighted guidelines" method of profit determination was not considered appropriate, the basis could have been set forth in the pre-negotiation clearance and a waiver requested to the appropriate ASPR provision.

2. I mention the above two points to indicate my concern that in our acquisition process there is required a mutual exchange of information, such that our recent exchange of correspondence on this matter would be unnecessary. I hope that I may have your personal support to the end that our staffs will freely review proposed contractual actions well in advance so that we can achieve our mutual goals of rapid and businesslike procurements of maximum benefit to the Navy.

I. J. [illegible]
[illegible]
[illegible]

Copy to:
ASN(I&L)
COMNAVSHIPS

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
08H-359
16 OCT 1968

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Westinghouse Electric Corporation Procurement of Nuclear Reactor Components

1. Your memorandum of 26 September 1968 is the latest in the series of correspondence concerning the fixed fee paid to Westinghouse Electric Corporation on a recent NAVSHIPS contract for nuclear reactor components. Your memorandum implies that this problem arose because NAVSHIPS rationale for paying proposed fixed fees was not properly documented. You asked for my personal support so that proposed contractual actions will be freely reviewed well in advance and mutual goals of rapid and business-like procurement of maximum benefit to the Navy can be achieved.

2. Documentation has nothing to do with the issue I raised. The point is, in my opinion, NAVMAT procurement officials should not be directing NAVSHIPS to pay higher fees.

3. My records indicate your office has reviewed 27 contract actions totaling about $449 million for work under my technical cognizance during the past four years. All these contracts provide for fixed fees of about 2.28% or less. I do not think NAVMAT approved these contracts without understanding the basis for these fixed fees. The nature of these contracts has been discussed in great detail on several occasions by the members of our respective staffs; specifically, with Admiral Bieri and his staff on August 14, 1964, with Admiral Howard and his staff on July 10, 1967, and again with Captain Freeman and his staff on August 27, 1968. Other discussions have been held from time to time. In each case, the decision has been made to proceed with the procurement as recommended by NAVSHIPS.

4. You can be assured of my support in the future, just as in the past, in achieving rapid and business-like procurement of maximum benefit to the Navy.

5. I trust this issue is now settled.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Assistant Secretary of the Navy (Installations and Logistics)
Commander, Naval Ship Systems Command
Division of Contracts, NAVSHIPS

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
08H-370
13 Nov 1968

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS & LOGISTICS)

Subj: Need for improvements in ship procurement practices

Encl: (1) Examples of Recent Procurements Recommended by Shipbuilders but Which Were Overpriced

1. The rising cost of naval ship construction has been a matter of considerable concern to the Navy. I believe that a large portion of the price increase in the Navy's shipbuilding program results from poor contracting practices.

2. There is little or no real price competition for shipbuilding contracts or for complex equipment that shipbuilders buy. However, for many years, the Navy has awarded shipbuilding contracts, and shipbuilders have awarded subcontracts, on the basis of "adequate competition".

3. Early this year, Navy procurement officials recommended awarding the DLGN 36-37 ship construction contract without negotiating because they considered the competition obtained from two bidders adequate, even though NAVSHIPS technical and project personnel found numerous indications that the low bidder's price was excessive. Ultimately, NAVSHIPS obtained permission to negotiate the price. Through negotiations, the low bidder's base price was reduced by $27,000,000.

4. Enclosure (1) contains several recent examples of shipbuilder procurement that indicate the inadequacy of the Navy's present procedures for ensuring reasonable prices for the Government under shipbuilding contracts. These examples were discovered because I require specific NAVSHIPS review and approval of major subcontracts for equipment under my technical cognizance. Normally, the Navy does not review subcontracts on a case-by-case basis. Instead, the Navy approves a shipbuilder's procurement system and then relies on the approved procurement system to obtain reasonable prices for the Government. From what I have seen, this procedure has not been effective.

5. Because competition for major ship construction contracts is limited, ship prices are influenced more by historical costs than by competitive market pressures. Since shipbuilders base their quotes on subcontractor bids, they have little incentive to negotiate lower prices after they receive a contract. In the long run, higher cost bases will generate higher profits, since profits are generally established as percentages of estimated cost.

6. I believe that the Navy should face up to the lack of true competition in the shipbuilding industry and among the suppliers of shipboard equipment. Competition in this field is the exception--not the rule.

7. I recommend that you initiate a review of shipbuilding procurement practices, placing particular emphasis on the lack of true competition available, both at the prime contract and subcontract levels and on the depth of contractor and government review being performed on these procurements. If carried out effectively, such a review should lead to improvements that could save the taxpayer many millions of dollars each year. Pending completion of this review, I recommend that you require specific Navy review and consent to all subcontracts in excess of $100,000 under cost reimbursement and incentive type contracts.

8. If I can be of further assistance, please let me know.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copies to:
CNM
COMNAVSHIPS

Examples of Recent Procurements Recommended by Shipbuilders But Which Were Overpriced

I. Main circulating sea water pump procurement

On May 17, 1968, Shipbuilder A requested NAVSHIPS approval to procure main circulating sea water pumps from the only bidder of seven companies solicited. The proposed price for these pumps was $311,000--about $75,000 more than Shipbuilder A paid in February 1967 for similar pumps used in construction of another type ship and about $152,000 more than was paid for pumps bought in 1964 for the same type ship. Shipbuilder A recommended the $311,000 price as reasonable based on increased technical requirements and known price escalation. He did not obtain and evaluate the suppliers' cost and pricing data as required by Public Law 87-653.

NAVSHIPS disapproved the proposed subcontract and asked Shipbuilder A to obtain and evaluate the supplier's cost data to insure that the price was reasonable. This data showed that the price of $311,000 would provide the pump supplier a $42,000 profit on direct labor costs of $4,707, subcontracts and materials totaling $213,387, and other costs, including sales expense, G&A and interest, totaling $50,694. Based on the suppliers' cost data, Shipbuilder A negotiated a price of $228,000 which was about the same price paid for similar pumps purchased eighteen months earlier. The negotiated reduction of about $85,000 consisted of a reduction in price, including profit, of about $45,000 and a reduction of about $40,000 in resolution of technical requirements. However, the reduced price still provided the pump supplier a profit of about 10% on his total costs and about 45% on his "in-house" costs. Without special review by NAVSHIPS, Shipbuilder A would have placed this order as a competitive deal and the cost to the Government would have been $85,000, or about 35%, higher.

II. Motor Generator Set and Voltage Regulator Procurement

On 14 August 1968, Shipbuilder A requested NAVSHIPS approval to place a firm price contract for motor generator sets and voltage regulators at a price of $513,488, including $122,500 for the voltage regulators. The supplier's cost breakdown indicated that the price of $122,500 for voltage regulators included a 33% profit on cost--a profit two to three times higher than would normally be paid under ASPR guidelines. In their submission to NAVSHIPS, Shipbuilder A stated this profit was considered reasonable since the items were "high risk" and the profit had been negotiated downward from 46%.

NAVSHIPS disapproved the proposed procurement. Shipbuilder A was requested to initiate an audit of the supplier's cost breakdown and negotiate a more reasonable price. Shipbuilder A subsequently advised NAVSHIPS that the preliminary audit report indicated questions relative to labor and material man hours. However, Shipbuilder A recommended placement at the price originally offered by the supplier since the supplier had indicated his total price was final and not subject to further negotiation. With respect to the high profits, Shipbuilder A indicated that the supplier was submitting a new cost breakdown to show higher costs, lower profit and the same price. On this basis, Shipbuilder A stated:

> In view of the competitive nature of this procurement, our evaluation of the reasonableness of the total price quoted and the urgent necessity for early placement of the order, we recommend that the Contracting Officer give us his consent to procure these sets from. . . at the total price of $518,488 as well as the stock components at a total price of $161,409, without waiting for the revised cost breakdown or the final audit report from DCAA. Attention is again called to the (supplier's name) position that the total price for these sets will not be reduced.

This procurement is still pending.

III. Main Sea Water Pump Procurement

Shipbuilder B recommended that NAVSHIPS consent to a $216,000 subcontract for main sea water pumps for which there was only one source.

Initially, the supplier refused to provide the cost data required by Public Law 87-653. NAVSHIPS insisted that Shipbuilder B obtain the required cost data. The supplier finally acquiesced. A Government audit of the supplier's cost breakdown showed the following:

(1) A 25% profit on his estimated costs.

(2) His cost estimate included $34,000 of other costs the Government auditor considered questionable. He had added a 20% factor to material costs, factory labor, and factory overhead costs to provide an allowance for possible defective work. A 10% factor was then added to each cost element for possible cost increases during the two-year period of contract performance. A 20% factor was then applied to the total cost less general and administrative expenses to compensate for the risks of Government inspection. The Government auditor could not obtain data to support these mark-up factors.

(3) The price included a $68,000 subcontract with another division of Shipbuilder B's parent corporation. This firm declined to furnish cost and pricing data to the pump supplier, the shipbuilder or the Government because the procurement was less than $100,000. Although this procurement was less than $100,000, the Navy's aggregate procurement of such motors from this firm, either directly or as a lower tier supplier, constitutes a very large sum since this firm i the Navy's leading supplier of quiet pump motors.

Shipbuilder B has been told to continue negotiations in order to obtain a more reasonable price and to obtain and provide data necessary to justify the reasonableness of the price. This procurement is still pending.

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

20 November 1968

MEMORANDUM FOR VICE ADMIRAL RICKOVER, USN

Subj: Ship Procurement Practices

Your memorandum of 13 November has been read with a great deal of interest. As you indicate, the rising cost of ship construction has been a matter of great concern to the Navy for some time. The entire matter of SCN pricing is being covered by the SCN Pricing and Cost Control Study Group headed up by Rear Admiral Sonenshein. As a part of this study, procurement practices are being encompassed but not to the degree suggested in your memorandum. I have therefore discussed this subject in detail with Rear Admiral Sonenshein. Both he and Admiral Galantin agree that consideration should be given to broadening the efforts of the Study Group to effectively encompass certain aspects of procurement practices, especially the sub-contract structure.

I also enlist your active support in providing any data requested by the SCN Pricing and Cost Control Study Group to support its study effort, as it may pertain to nuclear propulsion components being procured for the Navy shipbuilding program. To this end, the designation of a member of your staff as a focal point for such liaison would be appreciated.

Thank you for your suggestion.

Barry
BARRY J. SHILLITO

THE ASSISTANT SECRETARY OF THE NAVY
INSTALLATIONS AND LOGISTICS
WASHINGTON, D.C. 20360

25 November 1968

MEMORANDUM FOR VICE ADMIRAL RICKOVER, USN

Subj: Ship Procurement Practices

Reference is made to my memo of 20 November 1968 and our telephone conversation of this date relative to this subject. Apparently there has been some misunderstanding relative to the intent of my memo. I am primarily concerned with the SCN Pricing and Cost Control Study Group encompassing ship procurement practices in their study efforts rather than starting an additional review effort. While it is not necessary that their be participation from your organization I would like to hope that the study group can call on your organization for assistance and advice as necessary in order to make their efforts as meaningful as possible.

BARRY J. SHILLITO

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
Ser 08N - 1701
February 12, 1969

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS & LOGISTICS)

Subj: SSN685 - Electric Drive Submarine - Procurement of Main Sea Water Pumps

Ref: (a) NAVSHIPS memorandum ser 08H-370 dtd 13 Nov 1968
(b) ASN (I&L) memorandum dtd 20 Nov 1968

1. In reference (a), I advised the Assistant Secretary of the Navy for Installations and Logistics that I believed a large portion of the price increase in the Navy's shipbuilding program resulted from poor contracting practices. I described several recent examples of shipbuilder procurements that indicated the inadequacy of the Navy's present procedures for ensuring reasonable prices for the Government under shipbuilding contracts. In reference (b), Assistant Secretary Shillito said that my memorandum to him, reference (a), had been read with a great deal of interest. He said the entire matter of SCN pricing was being covered by a study headed up by Rear Admiral Sonenshein.

2. One of the examples given in reference (a) was the procurement of the main sea water pumps for the Electric Drive Submarine (SSN685). The sole source pump supplier initially refused to provide the cost data required by Public Law 87-653, yet the shipbuilder recommended NAVSHIPS consent to placing the order. I insisted that the shipbuilder obtain the cost data; this data showed that the price included excessive costs, unwarranted cost contingencies, and an excessive profit percentage on these excessive costs. I told the shipbuilder to continue negotiations in order to obtain a more reasonable price. The details are given in reference (a).

3. The initial price from the pump supplier was $262,340. During initial negotiations the shipbuilder obtained a price of $216,000 and recommended that NAVSHIPS consent to placing the order at this price. Following my insistence that cost data be obtained and further negotiations be conducted, the shipbuilder obtained a price of $176,800. The shipbuilder has advised NAVSHIPS that although this price is still too high it is the best he can obtain. The shipbuilder has recommended that NAVSHIPS consent to placing the order at this price.

4. The latest proposed price of $176,800 is still more than these pumps should cost. A large part of the unwarranted cost contigencies identified when the cost data was first submitted is still included in the price. As a result, the potential for excessive profit remains. However, we cannot delay further in placing this order. Negotiations have already been underway for more than a year and the order must now be placed so that late delivery of these pumps does not delay delivery of the Electric Drive Submarine itself. I have no choice but to agree to order placement at a price of $176,800.

Subj: SSN 685 - Electric Drive Submarine - Procurement of Main Sea Water Pumps

5. In reference (a), I made specific recommendations for improvements in ship procurement practices. I know of no action which has been taken to implement my recommendations. The latest developments on this procurement of the main sea water pumps for the Electric Drive Submarine is a further example of the need for action. I strongly urge you give this matter your personal attention.

H. G. RICKOVER

Copy to:
CNM
COMNAVSHIPS
NAVSHIPS 02

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20350

17 MAR 1969

MEMORANDUM FOR VICE ADMIRAL H. G. RICKOVER

Subj: Ship Procurement Practices

1. This is in response to your memorandum of February 12, 1969, regarding procurement of components for the Electric Drive Submarine. I am pleased to note that your efforts, and those of the Naval Ship Systems Command, have resulted in substantial reduction of the price proposed for the main sea water pumps. I am concerned, as you are, that maximum attention is paid to the subcontract area in our procurement process.

2. You also indicated that you knew of no action which had been taken to implement recommendations you had previously made with respect to ship procurement practices. However, as indicated in Mr. Shillito's memorandum of 20 November 1968, the matter of a subcontract structure in ship procurement has been incorporated as part of the study being conducted by the SCN Pricing and Cost Control Study Group, headed by Rear Admiral Sonenshein. The results of the subcontract review efforts to date indicate that there are several areas where improvements can be made. I had hoped to be more specific in my response by now but believe it appropriate that the entire study and all its conclusions be reviewed so that coordinated action may be taken on the recommendations. I look forward to an opportunity to discuss this study with you as soon as it has been completed.

3. Your continued interest is appreciated. As noted above, I want to discuss this matter in some detail with you. I would ask also for the cooperation of your staff in assisting in the study efforts underway in the Naval Material organization.

Frank Sanders

Frank Sanders
Assistant Secretary of the Navy
(Installations and Logistics)

Copy to:
CNM
COMNAVSHIPSYSCOM

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1324
28 March 1969

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY FOR INSTALLATIONS & LOGISTICS (I&L)

Subj: SSN685--Electric Drive Submarine--Procurement of Main Sea Water Pumps

1. My memorandum to you of February 12, 1969, summarized problems I am encountering in procuring the main sea water pumps for the Electric Drive Submarine. I sent you that memorandum as a first hand example of the Navy being forced to pay excessive prices because of inadequacies in present ship procurement practices.

2. In response, your memorandum dated March 17, 1969, stated that you want to discuss this matter with me in some detail, but after the Naval Material Command has completed a study of SCN pricing and cost control since the Naval Material Command study group had also found areas of subcontracting where improvements could be made. You requested the cooperation of my staff in assisting the study efforts underway in the Naval Material Command.

3. The procurement of main sea water pumps for the Electric Drive Submarine is an excellent example of why Navy ships cost more than they should. As pointed out in my previous memoranda on this procurement:

a. NAVSHIPS estimated these pumps should cost about $110,000 based on a previous procurement of the same design pump.

b. The sole-source pump supplier initially quoted a price of $262,340.

c. The shipbuilder conducted negotiations with the pump supplier; the price was reduced to $216,000.

d. NAVSHIPS did not accept this price and required the shipbuilder to obtain and evaluate the pump supplier's cost data; the price was further reduced to $176,800.

4. This is a low risk job for the pump supplier. The pump castings, which were the high risk items on previous procurements of this design pump, will be provided by the shipbuilder. In addition, the pump supplier has added a 20 percent contingency factor, which NAVSHIPS considers unwarranted, to his estimated costs to compensate for the risks of Government inspection. The motor, which is 45 percent of the supplier's basic estimated cost, is to be subcontracted on a firm-fixed-price basis. The motor subcontract is with another division of the shipbuilder's parent corporation.

5. Despite the low risk, the current price of $176,800 provides substantial profit to all contractors involved. The pump supplier has added a 20 percent profit to his total estimated costs, which include the cost of the subcontracted motor. If the contingency for Government inspection, as explained in paragraph 3 above, does not materialize, the pump supplier could realize a profit of more than 40 percent. The shipbuilder's parent corporation gets a double profit in this procurement--a profit on the price paid for the pumps under the shipbuilding contract and, in the $176,800 pump price, an additional profit paid to the division that sells the motors to the pump supplier.

6. My experience is that procurements such as this are commonplace under shipbuilding contracts. Competition is generally limited, yet shipbuilders seldom negotiate or effectively analyze supplier costs. The Truth-in-Negotiations Act has not been properly implemented by shipbuilders. Frequently, the subcontracts provide much higher profits than can be justified under the Department of Defense weighted guidelines method of profit computation. I believe this situation is evident without the necessity of a Naval Material Command study. The Navy can and should take prompt action to correct these deficiencies.

7. In view of your request that I cooperate with the Chief of Naval Material in this matter, I request, by copy of this letter, any assistance he can provide with respect to the procurement of these main sea water pumps for the Electric Drive Submarine. The order must be placed without delay so that the ship delivery schedule will not be delayed.

8. The problem facing the Navy in its ship procurement practices is an urgent one and leads to higher costs than necessary. Recent public statements by the Secretary of Defense indicate his dissatisfaction with the Navy's management of its shipbuilding programs and with the delays and cost increases of these programs. Various Congressional committees have also indicated that an investigation of the high price of Navy ships is in order. The Navy shipbuilding programs may be curtailed if shipbuilder procurement practices are not improved promptly and substantially.

9. I believe the matter is of sufficient importance to warrant your personal attention and direction.

H. G. RICKOVER
Deputy Command for
Nuclear Propulsion

Copy to:
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
MAT 02:RGF

7 MAY 1969

MEMORANDUM FOR VICE ADMIRAL H. G. RICKOVER, USN

Subj: Electric Drive Submarine - Procurement of Main Sea Water Pumps

1. I regret the delay in arriving at a resolution of the problems discussed in your memorandum of 28 March 1969.

2. The subcontractor has agreed to provide a certified "after the fact" cost of the procurement of subject pumps. He has also agreed to refund to the Government any costs which are less than those certified in his submission prior to contract. The later submission will be certified in accordance with PL87-653.

3. The contractor would not agree to a lesser profit rate on the subcontract. The matter of profits on the motor purchased from a division of the prime contractor will be the subject of discussions and negotiations with the prime at the time of settlement of the basic contract.

4. Although this resolution is not a completely satisfactory one, the agreement for "after the fact" cost information, the substantial decrease in price negotiated prior to your request for my assistance, and the stated urgency of the procurement are considered sufficient bases for granting consent to this subcontract.

I J Galantin

I. J. GALANTIN
Admiral, USN
Chief of Naval Material

Copy to:
ASN(I&L)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H Ser 1337

30 APR 1969

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS & LOGISTICS)

Via: (1) Commander, Naval Ship Systems Command
(2) Chief of Naval Material

Subj: Review of Controls over Construction Costs of Nuclear-Powered Ships at Newport News Shipbuilding and Dry Dock Company

Encl: (1) NAVSHIPS 08 Trip Report dtd 25 April 1969

1. The Naval Ship Systems Command is presently involved in three long term nuclear shipbuilding programs at the Newport News Shipbuilding and Dry Dock Company (Newport News). These programs are expected to result in negotiated contracts for a large amount of Naval nuclear ship construction work over the next several years. Newport News is presently constructing two nuclear-powered guided missile frigates, DLGN's 36 and 37, under a fixed-price incentive contract. In addition, under letter contracts, Newport News is building a nuclear-powered attack aircraft carrier, NIMITZ (CVAN 68), procuring long leadtime components for a second NIMITZ class aircraft carrier, CVAN 69, and procuring long leadtime components for a high-speed nuclear attack submarine (SSN 688). Since the Government bears nearly all the risk of cost overruns under these contracts, I recently had two of my representatives conduct a limited review to find out how Newport News controls shipbuilding costs on Navy contracts. A report covering this review is attached as enclosure (1).

2. This enclosure indicates the following deficiencies in controls over shipbuilding costs at Newport News:

a. Cost Controls. The present Newport News cost control system cannot be relied upon to control costs adequately under Navy shipbuilding contracts. A recent Newport News internal report stated "there is evidence of widespread mischarging of costs." There seems to be no comprehensive system of labor checks to ensure that work is charged properly. These deficiencies are important, particularly in connection with cost-type contracts, fixed-price-incentive contracts, and letter contracts. The Government bears most if not all the risk of cost overruns under these types of contracts. Newport News management acknowledged that their present cost control system is deficient and indicated that this problem had been recognized as early as 1966. Nevertheless, Newport News has not yet established an effective cost control system for naval ship construction. Enclosure (1) indicates that implementation of an improved cost control system for CVAN 68 and DLGN's 36 and 37 has been deferred until 1970. Meanwhile, construction of these ships and work under other Navy contracts where the Government bears the risk of cost overruns are proceeding without effective cost controls.

b. Procurement Practices. The Newport News procurement system cannot be relied upon to obtain minimum prices for material and equipment. Newport News tends to use competitive procurement procedures in non-competitive situations. For example, Newport News recently submitted for NAVSHIPS 08 technical review sole source procurements totaling $1.7 million for which they had not obtained and evaluated supplier cost and pricing data in accordance with requirements of the Truth-in-Negotiations Act (PL 87-653). As a result of the NAVSHIPS 08 review, Newport News was required to obtain the necessary data. After obtaining cost and pricing data, the company was able to negotiate price reductions totaling $230,000 on these procurements--13% less than the original prices it had recommended and which were forwarded without any recommendation by the Supervisor of Shipbuilding. Enclosure (1) indicates that Newport News is still not obtaining and using supplier cost and pricing data in all cases where this is required by current Department of Defense procurement regulations.

c. Navy Review of Newport News Procurements. The Navy's procedures for reviewing Newport News procurements have been ineffective. Even though materials and equipment account for about 40 percent of the costs of a shipbuilding contract, the Navy does not review individual subcontracts, regardless of dollar amount or degree of competition. Instead, about once a year, the Navy reviews the Newport News procurement system and based upon these reviews, has invariably authorized Newport News to place subcontracts without specific Government review and approval of individual subcontracts.

In November, 1968, a special Naval Ship Systems Command audit team reviewed the Newport News procurement system and concluded:

> The contractor's procurement system is adequate, affords maximum protection of the Government's interests and assures procurement of materials at the lowest price consistent with quality and required delivery schedules. (underlining mine)

My experience, to the contrary, is that the Newport News procurement system cannot be relied upon to obtain minimum prices for material and equipment. Considering the deficiencies found in recent months, I consider that Government review of individual subcontracts is essential if the Navy is not to be charged considerably higher costs than warranted for equipment and material.

d. Pricing and Administration of Change Orders. Neither Newport News nor the Government is presently able to determine the actual cost of changed work on ship construction contracts. Change orders have generally been found to increase shipbuilding contracts by 12 to 16 percent. Yet there is no way of verifying whether change orders have been over-priced. This is so because there is no record of actual costs for the work required to accomplish the changes. Further, as much as two-thirds of the estimated cost of a change is composed of standard "add-on" factors such as supervision, overtime, and general and service labor although it may not be proper to charge all of these "add-ons" to every change.

e. Internal Audits and Appraisals. Newport News does not appear to have a centralized program for systematic examination and appraisal of its internal operations. Their internal auditors seem to be concerned primarily with financial type auditing such as payroll accuracy verification, rather than with the efficiency of shipyard operations or effectiveness of cost control procedures.

3. Competition for nuclear-powered ship construction contracts is limited and in many cases non-existent. Since profits on shipbuilding contracts are computed as a percentage of costs, high shipbuilder costs result in higher profits in the long run. Under these circumstances the Navy cannot, in my opinion, afford to rely on shipbuilders to reduce ship construction costs.

4. Government contracts account for about 80 to 85 percent of the total work at Newport News. Since 1962, Newport News has received over $1.2 billion in Navy prime contracts. From my experience and as confirmed by the findings in enclosure (1), it appears that Newport News management, the Supervisor of Shipbuilding, and the Defense Contract Audit Agency have not taken adequate action to protect the U. S. Government against higher than necessary costs.

5. In view of the large value of Navy shipbuilding contracts at Newport News, I consider that as a minimum the following action should be taken:

a. Newport News should not be permitted to delay until 1970 implementation of effective cost controls for construction of DLGN's 36 and 37 and CVAN 68 and for other contracts where the Government bears the risk of cost overruns. Further, Newport News should be required to establish an effective system to insure that charges for naval ship construction work are valid and accurate.

b. The Navy should review each major purchase order over $100,000 and smaller orders on a spot check basis prior to order placement to insure that prices are reasonable and that Newport News is complying in all respects with the requirements of the Truth-in-Negotiations Act.

c. The Navy should require Newport News to maintain records of actual costs of work to accomplish change orders, particularly in situations where the change must be accomplished before a final change order price can be negotiated. Newport News should also be required to keep cost records which adequately support the reasonableness of pricing factors used in estimating the cost of changed work.

d. The Navy should require Newport News to establish an effective program of internal reviews and appraisals of its operations. The Supervisor of Shipbuilding should be required to review and monitor this program. In addition, the Supervisor should establish his own independent program of formal appraisals of Newport News operations that affect prices of Navy contracts.

6. The conditions described in the attached report should be of serious concern to the Navy. These problems are not unique to Newport News. If reviews similar

to this limited review at Newport News were conducted at other shipyards, the findings would be substantially the same.

7. It is becoming more difficult for the Navy to obtain authorizations for the ships it needs in view of the criticism by the Secretary of Defense and various Congressional committees over the constantly increasing costs of constructing naval warships. They have made repeated statements expressing dissatisfaction with the Navy's management of its shipbuilding programs and the resultant delays and cost increases. I am concerned that unless immediate steps are taken to improve control of shipbuilding costs, authorization of needed Navy ships will be curtailed.

H. G. Rickover
H. G. RICKOVER
Deputy Commander
for Nuclear Propulsion

Copy to:
Assistant Secretary of the Navy (Installations & Logistics)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08-1360
8 JUL 1969

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Actions by the Naval Material Command Procurement Control and Clearance Division -- Deleterious Impact on Naval Nuclear Propulsion Program

Ref: (a) Director, Procurement Control and Clearance Division, NMC, Memorandum to CNM dtd 18 Jun 1969
(b) CNM memorandum MAT 02:EGF Ser: 01762 dtd 20 Jun 1969 to COMNAVSHIPS
(c) PM 13 memorandum to CNM Ser: 023 dtd 25 Jun 1969
(d) COMNAVSHIPS memorandum to CNM Ser: 0416 dtd 27 Jun 1969
(e) CNM memorandum MAT 022/GWR Ser: 03195 dtd 22 Aug 1968 to COMNAVSHIPS

I have received a copy of a memorandum to you from Mr. G. W. Rule, Director, Procurement Control and Clearance Division of the Naval Material Command, dated 18 June 1969, reference (a), which was an enclosure to reference (b).

In his memorandum, Mr. Rule refers to a "potentially dangerous contracting situation" in existing and planned contracts with Newport News Shipbuilding and Dry Dock Company for construction of nuclear-powered carriers, submarines and frigates.

I do not know what caused Mr. Rule to write this memorandum. It appears he is concerned that General Dynamics may not be receiving adequate consideration for the lead ships of the new frigate and attack submarine classes (DXGN-1 and SSN 688). However, rather than discussing the basic considerations involved in the present planning for nuclear ship construction, he merely itemized the total nuclear construction work assigned or being considered for assignment to Newport News -- including contracts for which Newport News was the low bidder in competition with General Dynamics and another shipyard. The dollar value of Newport News work cited by Mr. Rule is overstated by a factor of two, and he neglects to mention that the ships involved are spread over seven authorization years (FY 1967 through FY 1973).

As brought out in comments by Admiral Lacy and Admiral Fahy (references (c) and (d)) with which I concur, most of the statements in Mr. Rule's memorandum contain errors. I do not understand why he made so many errors, since the correct information is readily available to him. His memorandum would indicate that he is not adequately familiar with the pertinent facts concerning the issues he raised. Several of these issues are basic to contract matters over which his Procurement Control and Clearance Division exercises authority.

I am concerned that a memorandum containing such inaccuracies could be presented to you for consideration. For this reason I consider it necessary to add my comments to those of Admirals Fahy and Lacy. The fact that Mr. Rule did not take the time to ascertain all of the facts before writing to you has required many senior officers and civilians to divert many hours to preparing memoranda to you to correct the inaccuracies in his statements. I know of three Admirals, three Captains who are Ship Acquisition Project Managers, and six senior civilians who have had to spend a collective total of more than 200 hours preparing, coordinating, and processing these memoranda through the chain of command. This effort had to be diverted from urgent Navy shipbuilding programs; there is simply no way to measure the adverse impact of such use of top Navy talent.

Unfortunately, this is not the first time my efforts and those of my senior people have been devoted to correcting statements made by Mr. Rule.

For years Mr. Rule has tried to change my method of contracting for nuclear propulsion plant components -- a method which has proven to be successful for many years. My people have had to spend much time explaining why Mr. Rule's proposals were not in the best interests of the Government.

As you know, NAVSHIPS places cost-plus-fixed-fee (CPFF) prime contracts with General Electric and Westinghouse to develop and furnish specific types of nuclear plants. The components for these plants are then procured from industry by these two prime contractors by means of competitive fixed price type subcontracts. Each of these subcontracts receives detailed technical and contractual review by NAVSHIPS. This procedure has been followed since the beginning of the nuclear propulsion program and has proven effective and economical in obtaining the components we need for safe and reliable operation of naval nuclear propulsion plants.

Notwithstanding this record, Mr. Rule in 1963 asked NAVSHIPS to change this method of contracting for nuclear components. The reason he gave was that the Department of Defense desired to reduce the dollar volume of CPFF contracts. He requested that NAVSHIPS use a contract scheme he had devised; this would show a decrease in CPFF contract amount by using, in effect, two contracts for each prime contractor -- a CPFF contract with the prime contractor for the prime contractor's own work, and a fixed price contract for all fixed price component subcontracts. Mr. Rule's scheme would enable the Navy to claim a "saving" of 25 cents on every dollar in the fixed price contract, since guidelines for measuring "savings" in the Department of Defense cost reduction program allow 25% of the dollar value of all fixed price contracts converted from cost-plus-fixed-fee contracts to be reported as "savings."

NAVSHIPS opposed this change since there would be no actual change in the amount of work being done on a fixed price basis; since the actual costs of administering two prime contracts or a two-part contract in place of one contract would be higher; and since there was no real benefit to the Government from the proposed scheme. After considerable time and effort by myself, my staff and senior officials in the Bureau of Ships and the Office of Naval Material over a period of months, the Vice Chief of Naval Material in 1963 agreed that in the circumstances my method of contracting was appropriate and should be continued.

Despite the 1963 decision of the Vice Chief of Naval Material, Mr. Rule, in July 1964, again raised this issue. At that time, without consulting me, he disapproved a proposed Bureau of Ships prime contract for nuclear components. Again he proposed his "two contract" scheme which would show an apparent reduction in the amount of CPFF contracting. Again it required much time and effort of myself, my staff, as well as top level personnel in the Office of Naval Material to resolve this issue. Because of Mr. Rule's continued insistence it finally became necessary for the Chief of Naval Material himself to review the issues involved. Following his review he concurred that my method of contracting was appropriate in the circumstances. He directed that he be informed immediately if further contract clearance actions by the Office of Naval Material would delay procurements for the naval nuclear propulsion program.

Mr. Rule, however, did not let the matter rest there. In a speech given on 3 May 1967 before the Naval Research Advisory Committee he recommended, among other things, that Project Managers, Systems Commanders, etc., should be precluded from "dictating types of contracts, by requiring all directives relating to type of contract to be reviewed and approved, prior to issuance by CNM." To support his recommendation he stated:

> "Admiral Rickover, for example, will not make an incentive or fixed price contract - only CPFF. Admiral Smith will not make a fixed price contract."

His statement was inaccurate, as were other statements in his speech. As he should know, for over 20 years I have insisted that nuclear components be procured under fixed price type contracts and subcontracts.

Shortly after this speech, RADM Howard, your then Deputy for Procurement, arranged a meeting among Mr. Rule, RADM Smith, RADM Jones, my representative, and others, to review Mr. Rule's statements. At the conclusion of this meeting, RADM Howard stated that Mr. Rule's statements reflected poor judgment concerning the matters covered in his speech.

In view of [illegible]s long background, I do not understand why Mr. Rule made the statement in his 18 June 1969 memorandum:

> "It is noted that . . . General Electric is the sole source for the nuclear propulsion plants for both classes of ships (DLGN and DXGN) despite the millions we have expended to maintain two contractors (General Electric and Westinghouse) in the reactor business."

As Admiral Fahy pointed out in reference (d):

> "The Navy has not spent millions to maintain two contractors in the reactor business. The Navy places prime contracts with General Electric and Westinghouse to develop and furnish specific types of reactor plants, the components for which are procured competitively from industry. The DXGN and the DLGN utilize the same reactor plant which was designed by General Electric. Since the components for the nuclear reactor plants for both types of ship are identical, it is more efficient and economical to procure them through the same prime contractor."

I could add more to this memorandum by discussing other instances where, in order to protect the interests of the Government, great amounts of my time and that of my senior people have been consumed because of Mr. Rule's actions in matters under my cognizance. For example, in 1967 and 1968 he delayed a number of contracts for nuclear components because he considered that the fixed fees to the contractors proposed by NAVSHIPS were too low. You will remember the exchange of correspondence initiated by Mr. Rule in 1968 when he disapproved placing one of these prime contracts. In this case he considered that NAVSHIPS should pay a higher fee to the contractor than NAVSHIPS considered appropriate -- a fee the contractor had accepted on similar contracts in the past. You will recall that I reluctantly agreed to increase the fixed fee by a nickel in order to avoid further delay in a $50 million prime contract. This exchange of correspondence -- the "nickel letters" -- is contained on pages 54 through 59 of the Joint Economic Committee Hearings on the Economics of Military Procurement, Part 2, November 14, 1968.

You may recall the issue mentioned by Admiral Fahy in reference (d) concerning the opposition of Mr. Rule's office to the negotiation of a contract with Newport News for the nuclear-powered frigates DLGN's 36 and 37. Mr. Rule's office wanted to declare the bids received from Newport News and General Dynamics to be competitive, and to award the contract to the low bidder -- Newport News -- but without negotiations. NAVSHIPS considered the bids too high and desired to negotiate with Newport News in order to obtain a lower price. Ultimately it required your decision, overruling the recommendation of Mr. Rule's office, to permit NAVSHIPS to negotiate with Newport News. As a result of these negotiations the Navy was able to obtain a substantial reduction in the price of these ships. However, the NAVSHIPS representatives spent more time in obtaining approval from the Naval Material Command to negotiate with Newport News than they spent in getting Newport News to agree to lower their price.

From my experience with Mr. Rule, it appears he does not understand all that is involved in procuring complex technical equipment. His statements indicate that Project Managers or Systems Commanders can or should readily adapt their programs and technical management to the type of contract he insists upon.

Mr. Rule has frequently raised contract issues relating to naval nuclear propulsion. No matter how many times an issue is resolved it keeps on rearing its head. These issues take up considerable time and effort -- time and effort which we need to devote to our technical work. Invariably, after these contract issues have been aired, Mr. Rule has been shown to be incorrect.

The issue facing me is my increasing inability to carry out my assigned responsibilities because of unwarranted interferences by those who do not share or contribute to getting the job done -- but have the authority to interfere at their volition. You must realize that the situation described in this memorandum is one of the examples of "over management" in the Department of Defense about which I have testified many times. You must recognize the deleterious effect it is having on the Navy.

It is important that this intolerably inefficient situation be remedied as soon as possible. I therefore request that you reassign responsibilities within your office so that Mr. Rule no longer has review or approval authority over contracts involving naval nuclear propulsion work.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Commander, Naval Ship Systems
  Command
Project Manager, SSN 688 and Later
  Design SSN Submarine Project (PM 13)
Director, Strategic Systems Projects Office

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON D.C. 20360

IN REPLY REFER TO
08M-1103
15 JUL 1969

From: Commander, Naval Ship Systems Command
To: Distribution

Subj: Technical Correspondence and Documents Exchanged Between Shipbuilders and the Government Regarding Work Under the Technical Cognizance of NAVSHIPS (08) in Ships Under Construction; Contractual status of

1. NAVSHIPS shipbuilding and design contracts provide for a considerable day-to-day interchange of technical correspondence between shipyards and the government or its design agents concerning matters under the technical cognizance of NAVSHIPS (08). For example:

a. Shipbuilders frequently submit proposed plan, technical manual, procedure and specification changes, and other technical correspondence to NAVSHIPS (08) and other government activities, reactor plant prime contractors, or the lead reactor plant design yard for action.

b. Lead reactor plant design yards submit many plans, documents, and other technical correspondence to NAVSHIPS (08) and other government activities for action.

c. Shipbuilding contracts specify that working plans, technical manuals, test procedures, and other design data for construction and testing of the reactor plants in nuclear powered ships will be furnished to the shipbuilder and are to be used without deviation. Reactor plant prime contractors, lead reactor plant design yards, and other activities furnish such design data, technical documents, and revisions thereto directly to shipbuilders.

2. Design data and technical documents furnished to the shipbuilder and technical replies to shipyard correspondence relating thereto are not intended to authorize contract changes and are not intended to require a contractor to take action not already within the scope of his contract. In some cases, shipbuilders have considered such technical correspondence as authorizing contract changes. For this reason NAVSHIPS considers that additional steps are necessary to ensure that there are no future misunderstandings concerning the contractual status of technical correspondence and other technical documents exchanged between shipbuilders and the Government or its design agents concerning matters under the technical cognizance of NAVSHIPS (08).

3. The following action is requested:

a. Shipbuilders

(1) Technical Correspondence to Government Activities, Reactor Plant Prime Contractors, or Lead Reactor Plant Design Yards - Shipbuilders are requested to include the following statement in all such correspondence concerning matters under the technical cognizance of NAVSHIPS (08):

> "The work that would result from approval of this submittal is within the scope of contract (s) (Insert appropriate contract numbers), and no change in the contract delivery or completion date or the current negotiated price or amount of any government contract with (Insert name of shipbuilder) is required."

If the above statement cannot be included in the submittal, the correspondence should be addressed to NAVSHIPS (08) via the cognizant Supervisor of Shipbuilding, citing the circumstances involved, the shipbuilder's estimate of the additional costs involved, the effect on ship delivery, and any alternate contractual arrangements considered necessary.

The above requirement does not apply to repairs or modifications to government-furnished reactor plant equipment. Repairs or modifications to government-furnished reactor plant equipment should continue to be handled in accordance with existing instructions.

(2) Reactor Plant Design Data and Technical Documents Furnished to Shipbuilders - Design data, technical documents, and revisions thereto furnished to shipbuilders by reactor plant prime contractors, lead reactor plant design yards, and other activities are issued on the basis that no change in the current negotiated price or amount, or contract delivery or completion date of any contract is involved. If the shipbuilder considers that the use of any such design data, technical documents, or revisions thereto requires a contract change, he shall not proceed with work affected by such design data or technical documents, but should promptly, and in any event within 20 days of receipt of such design data or technical documents, notify NAVSHIPS (08) in writing via the Supervisor of Shipbuilding of the facts and his reasons for considering that a contract change is required. However, in emergencies where:

(a) the circumstances do not allow sufficient time to notify NAVSHIPS (08) of the facts prior to the need to proceed with the work; and,

(b) the work must proceed to avoid hazards to personnel or facilities or to avoid additional cost to the Government,

the shipbuilder may proceed with work in accordance with the design data or technical document furnished. In such cases, the shipbuilder should notify NAVSHIPS (08) via the Supervisor of Shipbuilding as soon as possible, and in any event within 7 days, of his reasons for considering that a contract change is needed and the nature of the emergency which required his proceeding prior to notification of NAVSHIPS (08).

b. Lead Reactor Plant Design Yards

(1) Lead reactor plant design yards are requested to include the statement in paragraph 3.a.(1) above in future technical correspondence to NAVSHIPS (08) or other government activities. The statement should apply to both design work under design contracts and construction work under applicable shipbuilding contracts held by the shipyard. Where design or construction work proposed is not considered within the scope of applicable contracts, the correspondence should identify the estimated cost to perform the design or construction work involved, the effect on ship delivery, and any contractual arrangements considered necessary. In such cases, the shipbuilder is not authorized to perform design or construction work that is considered to be outside the scope of the contract until appropriate contractual arrangements are made.

4. The actions requested by this letter should be placed into effect expeditiously. Shipbuilders and lead reactor plant design yards are requested to confirm by 31 July 1969 that the actions requested by this letter are in effect.

5. The action requested by this letter is considered by NAVSHIPS to be within the scope of existing contracts, and no change in contract delivery or completion dates or in the current negotiated price or amount of a government contract is authorized.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Distribution:
Electric Boat Div., General Dynamics Corp.,
Groton, Via: SUPSHIP, Groton
Ingalls Shipbuilding Corp., Pascagoula
Via: SUPSHIP, Pascagoula
Newport News Shipbuilding and Dry Dock Co.,
Newport News, Via: SUPSHIP, Newport News
Electric Boat Div., General Dynamics Corp.,
Quincy, Via: SUPSHIP, Quincy

Copy to:
PNRO Rep., Groton (2)
PNRO Rep., Pascagoula
PNRO Rep., Newport News
Gen. Mgr., Bettis
Gen. Mgr., KAPL
Gen. Mgr., MAO
Gen. Mgr., PAD

GREER/surbey, x5710, 7-15-69, REVISED, RETYPED
GREER/surbey, 5710. 7-11-69, REVISED, RETYPED

NEWPORT NEWS SHIPBUILDING
AND DRY DOCK COMPANY TENNECO
NEWPORT NEWS, VIRGINIA 23607

July 25, 1969

VADM H. G. Rickover, USN
NAVSHIPS 08
Naval Ship Systems Command Headquarters
Washington, D. C. 20360

VIA

Supervisor of Shipbuilding
Conversion and Repair, USN
Newport News Shipbuilding and Dry Dock Company
Newport News, Virginia 23607

Subject: Technical Correspondence and Documents Exchanged Between Shipbuilders and the Government Regarding Work Under the Technical Cognizance of NAVSHIPS (08) in Ships Under Construction; Contractual status of

References:
(a) Ser 08M-1103 dated July 15, 1969
(b) Gen/4330, Ser 400-204 dated July 22, 1969

Dear Sir:

Effective August 1, 1969 the actions requested by reference (a), which was forwarded by reference (b), will be placed into effect.

With regard to paragraph 3.a(2) of reference (a) we will make every effort to meet the twenty day requirement; however, there may be cases such as receipt of large quantities of drawings, technical manuals, etc. in early stages of contracts or long complicated manual changes requiring comments from several of our divisions where we will need up to forty-five days to provide notification of a change.

Yours very truly,

L C Ackerman

L. C. Ackerman
President and Chief Executive Officer

Distribution on Page 2

GENERAL DYNAMICS
Electric Boat Division

August 20, 1969

Subject: Technical Correspondence and Documents Exchanged Between Shipbuilders and the Government Regarding Work Under the Technical Cognizance of NavShips (08) In Ships Under Construction, Contractual Status of

Reference: (a) NavShips Letter, 0814-1103 dated July 15, 1969

Commander
Naval Ship Systems Command
Department of the Navy
Washington, D. C.

Via: Supervisor of Shipbuilding
Conversion and Repair, USN
Groton, Connecticut

Sir:

In response to reference (a), you are advised that the Electric Boat division is instituting the procedures with respect to technical correspondence outlined therein. At the end of a 120 day period we will evaluate the effects of these administrative requirements.

Very truly yours,

GENERAL DYNAMICS
Electric Boat Division

/s/ J. D. Pierce

J. D. Pierce
General Manager

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO

13 September 1969

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS & LOGISTICS)

Via: (1) Commander, Naval Ship Systems Command
(2) Chief of Naval Material

Subj: Procurement Practices and Cost Control under Navy Contracts with Electric Boat Division, General Dynamics Corporation, for Design, Construction, and Overhaul of Nuclear Submarines

Ref: (a) NAVSHIPS ltr 08N ser 1337 dated 30 April 1969

Encl: (1) Report dated 8 September 1969 to VADM H. G. Rickover, USN, concerning Procurement Practices and Cost Control by Electric Boat Division, General Dynamics Corporation in the Design, Construction, and Overhaul of Nuclear Submarines

1. By reference (a) I advised you concerning inadequate controls over the cost of Navy ship construction and overhaul work, as well as deficiencies in procurement practices at the Newport News Shipbuilding and Dry Dock Company--all of which result in higher than necessary cost to the Government.

2. Enclosure (1) reports on inadequate controls over the cost of Navy ship design, construction and overhaul work at the Electric Boat Division of the General Dynamics Corporation. The report shows that the Government is paying more than it should for the work being done; that there are widespread deficiencies in procurement practices; inadequate control over labor and material costs charged to Government contracts; and inadequate Government surveillance of contractor operations.

3. From the report it appears that deficiencies in administration of Government contracts have been used by General Dynamics to obtain what is, in effect, a multi-million dollar interest-free advance of Government funds. Further, General Dynamics has, in the last few years, considerably reduced its capital investment at Electric Boat while at the same time the Government has substantially increased the rate of profit being paid for the work being done there.

4. Shipbuilding procurement practices such as those cited in the attached report and in reference (a) have resulted in millions of dollars of unnecessary costs to the Government, thereby preventing the Navy from obtaining the ships it so vitally needs as well as wasting public funds. By sanctioning these practices for many years, the Navy has failed to protect the Government's interests.

5. The attached report is based on a limited check of readily available information. Therefore, the examples given in the report are merely indicative of many similar ones. It is obvious that serious deficiencies such as those described are pervasive at Electric Boat. The situation warrants further investigation by experienced procurement and cost control specialists to establish the full facts and to develop comprehensive corrective measures to preclude in future, such waste of Government funds at Electric Boat as well as at other yards.

6. Over a period of years I have advised the Office of the Assistant Secretary of the Navy (Installations and Logistics) and others of the need for substantial improvement in Navy shipbuilding procurement practices. I have pointed out that the rising cost of our ships is in part due to excessive prices for materials and equipment caused by poor shipbuilder procurement practices; to excessive costs of shipyard work; to inadequate shipyard cost control procedures; to the method of contracting for Navy ships--rewarding higher cost with higher profit; and to inadequate Government administration of shipyard contracts.

7. I know of no effective action taken to date to correct this situation. My memoranda on this subject have been referred for study to successively lower echelons of Navy management. Meanwhile, considerable Government funds are being wasted. The issues are clear. I see no need for further studies. Immediate corrective action can be taken if we really mean to give more than lip-service to "economy in Government."

8. Electric Boat is not in reality a "private" contractor. It conducts its operations in a non-competitive environment, 98% of its business being with the Government. For this reason the Government has a direct financial interest in all aspects of Electric Boat's operations involving cost and efficiency. The Navy must establish appropriate controls at Electric Boat and at other shipyards.

9. Specifically as to Electric Boat, I recommend the following:

a. Withdraw Navy approval of the procurement system. The Company should be required to submit all proposed subcontracts in excess of $25,000 for Government review and approval prior to placement.

b. Withdraw approval of Electric Boat's accounting system until effective controls are established to preclude mischarging of labor and material costs on Government contracts.

c. Revise progress payment procedures so that General Dynamics no longer gets interest-free use of Government funds.

d. Issue instructions to preclude the Government from financing development of the Arctic submarine tanker and other commercial ventures.

e. Issue policy instructions to preclude employment of former contractor personnel in positions where they are responsible for reviewing contractor operations in the activity where they were formerly employed.

f. Require that the decision as to whether work should be performed in-house or subcontracted (make or buy) as well as the decision to assign work to other General Dynamics divisions be reviewed and approved in advance by the Government.

g. Establish principles, procedures and the means to place the Government on an equal footing with the contractor in settling change orders and claims.

h. Assign a team of experienced procurement and cost-control specialists to conduct a thorough investigation of procurement and cost control practices and to develop a comprehensive corrective action program so as to preclude further waste of Government funds.

10. I doubt that the deficiencies listed in the attached report, or in reference (a), are unique to Electric Boat or to Newport News. I believe a detailed investigation would find that the conditions existing at these two companies are endemic throughout the defense industry. It should be obvious that present Department of Defense contracting systems and enforcement practices are inadequate for today's highly complex and large-scale military procurement. For this reason, I recommend that the Department of Defense take steps to:

a. Ascertain the extent to which conditions similar to those found at Electric Boat and Newport News obtain at other shipyards and at the facilities of other contractors performing work under Department of Defense contracts.

b. Establish specific provisions in the Armed Services Procurement Regulations (ASPR) to preclude similar deficiencies in Government contracting.

c. Reform and improve administration of defense contracts to protect the Government's interests.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Assistant Secretary of the Navy (Installations & Logistics)
Chief of Naval Material

REPORT TO ADMIRAL RICKOVER CONCERNING PROCUREMENT AND COST CONTROL PRACTICES BY ELECTRIC BOAT DIVISION, GENERAL DYNAMICS CORPORATION IN THE DESIGN, CONSTRUCTION AND OVERHAUL OF NUCLEAR SUBMARINES.

8 September 1969

REPORT TO ADMIRAL RICKOVER CONCERNING PROCUREMENT AND COST CONTROL PRACTICES BY ELECTRIC BOAT DIVISION, GENERAL DYNAMICS CORPORATION IN THE DESIGN, CONSTRUCTION AND OVERHAUL OF NUCLEAR SUBMARINES

I. Background and Conclusions

Ninety-eight percent of the work performed at Electric Boat is under Navy contracts. The backlog of Navy business at Electric Boat as of January, 1969, was $829,000,000. Except for the FY 1966 submarine procurement, all major contracts now being performed by Electric Boat for the Navy appear to have been awarded on a sole-source or non-competitive basis. All major contracts except for the FY 1966 submarine contract, which is firm-fixed priced and 80% complete, are cost-type or fixed-price incentive contracts where the Government shares in cost overruns and cost underruns. In 1968, half of the work performed by Electric Boat was under cost-type contracts. Since profits on Navy contracts are negotiated as a percentage of costs, rising costs can mean higher profits for Electric Boat on future contracts. In these circumstances the effectiveness of Electric Boat's cost control and procurement practices assumes great importance to the Government.

At your request, I reviewed Electric Boat's procurement and cost control practices to determine if these practices are adequate to obtain Government work at minimum cost. Because of the magnitude of Electric Boat operations my review was necessarily a limited one. It consisted principally of spot checks of readily available files and other information, and discussions with various Government and Electric Boat officials.

My review indicates that the Government is paying far more than it should for work at Electric Boat; that there are widespread weaknesses and deficiencies in Electric Boat procurement practices; that there is inadequate control over labor and material costs charged to Government contracts; that unwarranted charges are being made to Government contracts; that Government surveillance of contractor operations is inadequate. It appears that General Dynamics has exploited weaknesses in the administration of Government contracts at Electric Boat to obtain what amounts to a multi-million-dollar interest-free advance of Government funds. Further, in the last few years, General Dynamics has drastically reduced its capital investment at Electric Boat while at the same time the Government has substantially increased the rate of profit being paid on Electric Boat contracts.

From my review I believe that Electric Boat is wasting millions of dollars of Government funds because of inadequate management of its procurement and cost control functions under Government contracts. The Government bears the responsibility for much of this waste by the manner in which it is administering its contracts. Under present procedures the Government tends to rely on the contractor to look out for Government interests and has not taken adequate steps to insure that the contractor is doing so.

As stated above, my review was limited and based upon readily available information. The extent and seriousness of the deficiencies which I found indicates that the situation at Electric Boat warrants thorough investigation by a team of trained procurement and cost control specialists who could review these matters in detail to develop a comprehensive program of corrective action, so as to prevent further waste. I believe the Government will have to provide for more intensive surveillance and supervision of Electric Boat business operations than it has in the past.

CONTENTS

I. Background and Conclusion

II. Contents

III. Summary of Findings

a. Procurement Practices:

1. Procurement files do not adequately justify prices being paid by Electric Boat.

2. There seems to be an excessive and unwarranted amount of sole-source procurement. It appears that many of these sole-source procurements have been overpriced.

3. Electric Boat is not making effective use of the Truth-in-Negotiations Act to obtain the lowest possible prices for the Government.

4. Insufficient effort is being expended to reduce the cost of supplies and materials charged to Government contracts.

5. Competitive procurements are not handled properly. As a result, there is no assurance that all qualified firms have an equal opportunity in the bidding process or that reasonable prices are being obtained.

6. The lax procedures and practices employed in the procurement of equipment and material for Government contracts are in sharp contrast with the close attention paid by Electric Boat and General Dynamics Management in procurements involving corporate funds.

B. Charging of Material and Labor Costs:

1. Material Costs

a. Electric Boat's material control system contains serious deficiencies such that the validity of material costs charged to Government contracts cannot be determined.

b. Through questionable material charging practices, Electric Boat is charging the Government for material that remains in inventory and for material that Electric Boat itself has not paid for.

2. Labor Costs

   a. Under the present labor charging system supervisors have a strong incentive to charge labor costs to the labor budget account that can best absorb the cost and not necessarily to the budget account for the work actually performed.

   b. A comprehensive review of Electric Boat's labor charging practices has not been conducted. However, there are indications that labor costs are being mischarged. There are no effective controls to preclude such mischarging.

C. Change Orders and Claims:

1. Under the present system, there is no way to insure that the Government is not being overcharged in the adjudication of changes or in the settlement of claims.

2. Present procedures for handling claims against the Government for changed work seem to be heavily weighted in favor of the contractor.

D. Government Surveillance of Operations at Electric Boat:

1. Government representatives place undue reliance on Electric Boat's procurement system to obtain reasonable prices for the Government.

2. Although Government business accounts for 98 percent of the work at Electric Boat, Government auditors do not have access to certain Electric Boat financial reports that are essential in determining the reasonableness of charges to Government contracts.

3. Government representatives do not review the company's "Make or Buy" decisions and there are indications that such decisions are not always made with the interests of the Government foremost.

4. The Supervisor of Shipbuilding does not review Electric Boat procurements from other divisions of General Dynamics Corporation. The contractor does not justify the cost of these procurements or indicate whether or not these items are being obtained at less cost than would be possible from other companies.

5. The Supervisor of Shipbuilding does not adequately review major areas of cost at Electric Boat considering that the Government ultimately pays at least 98 percent of these costs.

6. A number of former Electric Boat employees are working in the offices of the Supervisor of Shipbuilding and the Government Auditor. This situation is not conducive to proper business relationships between the Government and Electric Boat.

7. There are indications of some recent improvement in Government surveillance of Electric Boat. However, the Government must take much stronger action to correct the fundamental deficiencies at Electric Boat.

E. Profits and Contractor Investment

III. Summary of Findings:

A. Procurement Practices:

Subcontracted work accounts for about one-third of the construction costs of a nuclear submarine. In 1968 the Electric Boat procurement department awarded subcontracts in the amount of $53 million. So far in 1969, Electric Boat is subcontracting at an annual rate of about $86 million. A review of about 40 procurement files revealed numerous deficiencies and fundamental weaknesses in Electric Boat's procurement procedures and practices. The deficiencies in procurement practices were common and widespread. The Government could save substantial sums by simply requiring Electric Boat to improve its procurement practices.

The following are specific examples from Electric Boat's procurement files which illustrate these deficiencies:

1. Procurement files do not adequately justify prices being paid by Electric Boat:

Of the 40 procurement files reviewed, there was no evidence of actual return cost information from prior orders being used to justify proposed costs. Electric Boat is not using pre-award audits or detailed independent estimates to evaluate, negotiate and justify prices in sole-source and other non-competitive procurements as required by the Armed Services Procurement Regulation. For example:

a. Procurement of Shaft Seals:

Electric Boat has bought shaft seals exclusively from Sealol Company for a number of years without requesting bids from other suppliers. The procurement files contain no detailed independent estimate of what these seals should cost and no adequate justification of the price paid. Electric Boat has never audited Sealol to see if actual costs for manufacturing these seals were consistent with prices being paid. Recently, the first Government audit of an Electric Boat procurement of these seals was completed--after the order was placed. The Government auditor questioned costs of $36,701 in the $119,910 price.

b. Procurement of Pumps:

On January 7, 1969 Electric Boat recommended procurement of certain pumps from Ingersoll-Rand at a price of $523,741. Ingersoll-Rand was the sole bidder; nevertheless Electric Boat had not obtained supplier cost and pricing data. Electric Boat stated that the price was reasonable based on its own evaluation and independent cost estimate. Electric Boat further stated that Ingersoll-Rand would supply cost and pricing data direct to the Government Contracting Officer, if requested. The Contracting Officer withheld consent to the procurement pending Ingersoll-Rand's submittal of certified cost and pricing data as required by the Truth-in-Negotiations Act. The data were submitted by Ingersoll-Rand on 12 March 1969. On 20 March 1969, the Contracting Officer consented to placement of this order at the price recommended by Electric Boat in order to avoid further delay to this equipment, which was critical to ship construction schedules. However, the Contracting Officer requested a post-award audit to insure that the price recommended by Electric Boat was not based on defective cost or pricing data. The post-award audit was completed on 24 July 1969. The following are excerpts from this report:

> "There is no cost accounting system maintained by the Foundry Division. Subcontractor's representatives have advised us that the estimated costs of castings are predicated on prices charged by a competitor, the Lebanon Steel Foundry of Lebanon, Pennsylvania. We

> were also advised that a cost accounting system will be installed at the Foundry Division in the near future; however, no firm data could be provided. Accordingly, we do not consider the subcontractor's estimating practice for proposing the cost of castings to be acceptable..."
>
> "...The subcontractor was unable to provide an analysis of labor costs which indicated the number of proposed labor hours..."
>
> "...We were unable to ascertain the reasonableness of the proposed Foundry costs or the costs related to development, paint and pack, spare parts, etc., for reasons stated earlier and, also, because no historical cost data were avialable for comparison purposes..."
>
> "...The proposed costs for the balance of the items comprised material costs, including development (pattern making), paint and pack, spare parts, test and reports, were based solely on engineering 'best judgement'..."

The auditor questioned $232,675 of the $511,447 fixed price paid by Electric Boat. His report states that Ingersoll-Rand requested that these findings not be disclosed to Electric Boat. Thus it appears that there was no sound basis for the price recommended by Electric Boat. This matter is still pending.

2. There seems to be an excessive and unwarranted amount of sole source procurement. It appears that many of these sole-source procurements have been overpriced:

Electric Boat's Manager of Purchasing stated that about 60% of the company's procurements are sole source. Most of the procurement files do not indicate why the procurement has to be sole source or what efforts have been made to find or develop other qualified suppliers. In many cases, Electric Boat procures materials and equipment from the same supplier year after year without checking to see if the materials or equipment could be procurred more economically from other sources. Further, Electric Boat makes little or no effort to seek bids from other suppliers who appear to be qualified to perform the work for certain repetitive procurements. The following examples from Electric Boat's procurement files illustrate the point.

a. Procurement of Shipboard Furniture:

In December 1968, Electric Boat awarded two sole-source subcontracts totaling $515,000 to R. L. Hanson Company. R. L. Hanson was to provide shipboard furniture for the FY 1967-68 submarine contract for which Electric Boat is the lead yard and the Ingalls Shipbuilding Corporation is the follow yard. Electric Boat negotiated its procurement based on total quantities required by both shipyards to take advantage of a quantity discount. Electric Boat priced its quantities on this basis and obtained an option for Ingalls. The Electric Boat contract included a provision that increased the price for the Electric Boat quantities if Ingalls did not exercise the option for follow-on quantities.

A note in the Electric Boat procurement file stated:

> "There is no technical or quality reason why R. L. Hanson is a sole source vendor. It is purely a matter of Electric Boat Division's chosen method of handling the furniture program."

A Government representative at Ingalls stated that in the past Ingalls has bought its shipboard furniture from other suppliers and that in this case Ingalls had decided to solicit competitive bids rather exercise the option Electric Boat obtained from R. L. Hanson. As a result, the price of the Electric Boat subcontract with R. L. Hanson had to be increased by $50,000 to adjust for the lesser quantity. Thus it is clear that:

(1) There are other firms that can supply shipboard furniture for nuclear submarines.

(2) Because Electric Boat did not solicit competitive proposals so as to insure that the price they had obtained was the lowest obtainable, separate procurement action had to be taken by Ingalls.

(3) The price of the Electric Boat order was increased by $50,000 or about 10% because the total quantity was not procurred from a single source.

There were other questionable aspects in this procurement. First, R. L. Hanson was only a "middle man". He received an $84,300 markup on the contract and then subcontracted the work to two furniture manufacturers. An Electric Boat memorandum to file states:

> "Mr. Hanson is reported to have vested interests in the two sources he uses... It is estimated that EB and follow yard business represent 75% of R. L. Hanson's workload. EB has been working with Hanson for many years."

A Government audit initiated after the order was placed questioned all costs and stated:

> "Our review of the proposal disclosed that a major portion of the cost pertained to subcontracting work to be performed by second tier subcontractors. All the items to be fabricated under these subcontracts are to be drop-shipped directly to the prime contractor. The subcontractor's proposals were submitted on DD Forms 633... (Note: the basic proposal was not)...As stated in exhibits (a) and (b), the contractor's records were not maintained in such a manner as to provide a ready determination of contract costs. In addition, the DD Forms 633 were based on pricing data rather than on cost information."

Thus there seems to be no way to determine whether or not the prices paid by Electric Boat for shipboard furniture are reasonable.

b. Procurement of Valve Actuators:

Electric Boat originally placed a small order with Sargent Industries for a new design valve actuator. Another firm, Parker Aircraft, was the low bidder; however, Electric Boat stated Sargent Industries was the preferred supplier for technical reasons.

A $168,112 follow-on production order was later awarded to Sargent on a sole-source basis. At that time a third firm, Hydromatic Company, protested to Electric Boat that it was fully qualified to manufacture these actuators but that it was not permitted to bid.

Subsequently, Electric Boat placed five other sole-source orders totaling over $800,000 with Sargent Industries for actuators without auditing the price. A fourth firm, Flo-Tork, Incorporated, submitted several unsolicited bids that were lower than Sargent prices. Protests by Flo-Tork prompted a Congressional inquiry from Representative Ashbrook of Ohio. Electric Boat responded that Flo-Tork's exceptions to certain standard Electric Boat contract clauses were unacceptable. The files indicated that on the same day Flo-Tork had withdrawn all exceptions to Electric Boat terms and conditions, Electric Boat had, nevertheless, awarded all five orders to Sargent Industries. From the extensive interest expressed by other firms in becoming qualified suppliers of valve actuators it is obvious that additional sources for this equipment are available or could be developed in order to encourage competition.

c. Procurement of Steel as an "Add on" to an Existing Order:

A June 1968 Government procurement system audit indicated that Electric Boat added additional supplies and equipment to existing orders without giving other suppliers a chance to bid, thus eliminating competition.

It appears that this deficiency remains uncorrected. For example, Electric Boat placed a subcontract with U. S. Steel in the amount of $225,000. The U. S. Steel bid was slightly lower than the bid of Lukens Steel. Within three months after placement of this order, Electric Boat added another $111,601 to this order for additional items without contacting Lukens, or any other supplier to see if a better price could be obtained.

3. Electric Boat is not making effective use of the Truth-in-Negotiations Act to obtain the lowest possible prices for the Government:

Until about a year or so ago Electric Boat had not been obtaining cost and pricing data required by the Truth-in-Negotiations Act (Public Law 87-653) in non-competitive procurements. As a result of emphasis placed on compliance with the Truth-in-Negotiations Act in connection with several procurements in the nuclear area, Electric Boat appears to be making greater effort to obtain this required data. However, the procurement files indicate that the cost and pricing data provided by suppliers are not used to justify subcontract prices. The files indicate that no real analysis of supplier cost and pricing data is made and that there is little, if any, negotiation of individual elements of costs in arriving at the final price. The reasonableness of individual cost elements usually cannot be established from information in Electric Boat's procurement files.

From reviewing these procurement files it appeared that Electric Boat procurement personnel regard the act of obtaining supplier cost and pricing data in non-competitive procurements sufficient to meet the requirements of the Truth-in-Negotiations Act. The data did not seem to be used. In many cases it appeared that the price had been established and the decision to award the purchase order made before the supplier's cost and pricing data were obtained. It appears that the cost and pricing data were requested only to give lip-service to the requirement that such data be obtained.

Certain actions on the part of the Government representatives at Electric Boat tend to belittle the importance of supplier cost and pricing data in determining the reasonableness of prices. For example, the local Government representative in several instances has consented to proposed Electric Boat procurements contingent upon Electric Boat obtaining certified cost and pricing data from the supplier. Thus, Electric Boat may have the impression that the cognizant Government officials do not consider supplier cost and pricing data to be an essential factor in determining the reasonableness of prices obtained by Electric Boat or a useful tool for negotiating lower prices.

In some cases Electric Boat has arranged to have suppliers send cost and pricing data directly to Government representatives rather than requiring them to submit the data to Electric Boat. Electric Boat makes this arrangement in cases where its suppliers state that they are unwilling to release cost and pricing data to Electric Boat but are willing to provide the data to the Government. By not insisting that suppliers provide certified cost and pricing data to Electric Boat, Electric Boat has no sound basis for determining the reasonableness of their prices in a non-competitive situation. Further, Government representatives have placed themselves in a difficult position when they accept supplier's cost and pricing data that cannot be released to Electric Boat. In such cases, Government representatives must either accept the pricing proposed or enter into negotiations directly with the supplier. Government representatives have been accepting the proposed pricing in such situations. For example, Electric Boat was attempting to procure steel flasks. The steel supplier refused to submit cost and pricing data to Electric Boat, so arrangements were made by Electric Boat to submit the cost and pricing data directly to the Government. Upon reviewing the supplier's cost and pricing data, the Government auditor stated in his report:

> "Do not inform the buyer (Electric Boat) of the facts above, especially the profit factor of 20.1 percent. This request was made by the vendor."

The Government representative at Electric Boat did not advise Electric Boat of the large profit and the contract was awarded at the price originally proposed ($738,372) without further negotiation.

Electric Boat procurement files indicate that the Truth-in-Negotiations Act has not been implemented properly by Electric Boat and consequently it is not resulting in lower prices for material and equipment procurred by Electric Boat. Substantial reductions in the price of subcontracted material and equipment should be possible if Electric Boat properly implemented the Truth-in-Negotiations Act. For example, Electric Boat submitted a recommendation to the Naval Ship Systems Command (NAVSHIPS) to buy main sea water pumps from a sole-source supplier at $216,000 without obtaining cost and pricing data. On the recommendation of Naval Reactors, the NAVSHIPS Contracting Officer rejected this proposal and requested that cost and pricing data be obtained from the supplier and a revised procurement recommendation be submitted based on the reasonableness of the vendor's costs. As a result of evaluating the supplier's cost data, the price was negotiated down from $216,000 to $176,800.

4. Insufficient effort is being expended to reduce the cost of supplies and materials charged to Government contracts:

In a number of cases it appeared that Electric Boat made little or no effort to find more economical ways to obtain material and equipment for use on Government contracts. For example:

a. Electric Boat generally procures repair parts through the original equipment supplier without first checking whether they could be procurred more economically by soliciting competitive bids from other suppliers. Procurement files indicate Electric Boat placed spare part procurements of $208,440 for common valve actuator parts, $27,000 for shaft seal spare parts, $17,030 for furniture spare fixtures, and numerous other spare part orders with the original equipment supplier with no justification indicated as to the need to procure these spare parts on a sole-source basis.

My prior experience at another prime contractor activity was that many repair parts can be bought competitively at substantially lower prices than can be obtained from the equipment supplier. In many cases, repair parts could be bought competitively for about half of what an equipment supplier would charge for the same part.

b. The General Services Administration (GSA) Office in the Boston Region stated that Electric Boat, as a predominately Government prime contractor, is authorized to procure supplies through the GSA, thereby taking advantage of quantity and other discounts available to the Government. Last year Electric Boat bought commercially about $2.7 million of general purpose supplies, none of which were procurred through GSA. At another prime contractor location, prices obtained through GSA were substantially, in some cases 50% or more, below the normal commercial market prices. Electric Boat has not made the effort to take advantage of this potential cost savings.

c. Another Naval Reactors representative at Electric Boat found that the price Electric Boat was paying for certain chemicals used extensively in the construction and overhaul of nuclear ships was twice that listed in the Navy Stock Catalogue for the identical items.

5. "Competitive" procurements are not handled properly. As a result, there is no assurance that all qualified firms have an equal opportunity in the bidding process or that reasonable prices are being obtained:

Electric Boat's procurement files indicate that competitive bidding practices are loose and that there are no effective safeguards to insure that all bidders compete on an equal footing for Electric Boat business or that reasonable prices are being obtained. Bid due dates are not enforced. Not all bidders are advised of significant changes such as extensions of bid due dates or changes in quantities to be procured. Bids are opened individually by the buyer when received without following a formal bid opening procedure.

Electric Boat's competitive bidding practices are such that there is no way to insure that the low bidder did not have access to bid information from other suppliers. The following chronology was prepared based on a review of Electric Boat's procurement of hull fittings for the FY 1967-68 submarines and for SSN 685. In these procurements the low bidder was also the last firm to submit a bid; bids were received and opened over a period of more than three weeks; not all bidders were granted the same extension to their bid due date or advised of changes in quantities. The following chronology illustrates the manner in which this Electric Boat "competitive" procurement was conducted:

Chronology of Competitive Procurement of Hull Fittings From Morland Tool Company

FY 1967-68 SSN Procurement

24 Jul 1968	Inquiry Issued: 6 August Established As Bid Due Date
30 Jul 1968	Inquiry Modified to Add Option For One Additional Set. (SSN 685) All Suppliers Notified Except Morland Tool. No Extension of Bid Due Date Was Indicated.
1 Aug 1968	First Bid Received and Opened
9 Aug 1968	Second Bid Received by TWX
23 Aug 1968	Third Bid Received by TWX
	Fourth Bid Received and Opened (Price $39.51 each)
	Morland Bid Received by Telephone (Price $39.00 each)
18 Sep 1968	Fourth Bidder Asks Permission to Revise His Bid
	Electric Boat Denies Fourth Bidder Permission to Revise Bid
17 Oct 1968	Order Placed With Morland Tool at $38.50 each With No Provision Made For Additional Shipset Quantity For SSN 685. Total Price $191,730.

SSN 685 Procurement

15 Apr 1969	Bids Solicited For SSN 685 Quantities: Bids Due 30 Apr
30 Apr 1969	2:30 P.M. First Bid Received
	4:10 P.M. Morland Tool Asks For Bid Extension to 7 May 1969
1 May 1969	Electric Boat Grants Morland Request and Advises All Suppliers Except First Bidder of Revised Bid Due Date
7 May 1969	Second Bid Received
	Morland Bid Received (Price $46.50 each) Electric Boat Offers Order to Morland at $45.00 each
9 May 1969	Morland Accepts Electric Boat Offer
12 May 1969	Third Bid Received ($50.13) Voided As Late By Electric Boat

Later	Note to File That Another Bid Received Was Rejected As Being Late
22 May 1969	Purchase Order Placed With Morland At A Total Price of $56,025.

The files indicate that Morland Tool may be receiving favored treatment over its competitors. Thus there is no assurance that the Government is paying the lowest competitive price in these procurements.

6. The lax procedures and practices employed in the procurement of equipment and material for Government contracts are in sharp contrast with the close attention paid by Electric Boat and General Dynamics Management in procurements involving corporate funds:

Electric Boat takes special precautions when procurements involve corporate funds. For example:

a. Procurements involving over $300 in corporate funds must be approved by the Electric Boat Comptroller. Proposed procurements over $10,000 must be approved by General Dynamics Corporate officials if corporate funds are involved. By comparison, a $250,000 subcontract charged to the Government can be given final approval by a senior purchasing agent in the Electric Boat Procurement Department.

b. Electric Boat follows a formal procedure in selling scrap for its own account to insure that bid information is properly controlled. Sealed bids are opened at a designated time, the bids are abstracted and the bid abstract signed, all in the presence of three witnesses. As mentioned earlier in this report, bids received under Government contracts are opened by the buyer upon receipt with no safeguards, witnesses or formal procedures equivalent to those used by Electric Boat in selling its scrap.

c. To insure that the lowest possible price had been obtained by the Electric Boat Division in one procurement involving corporate funds, General Dynamics called in its auditors from San Diego to verify labor charges of $52,755 from a subcontractor on a building expansion job. In another case involving a potential sole-source procurement of a 50 ton crane, Electric Boat contacted 8 other possible suppliers and obtained written statements that they were not capable of supplying the item. Electric Boat then challenged the $73,900 list price for the crane and through negotiations reduced the price to $68,500.

Procurements of the same magnitude that involve Government funds do not receive comparable attention. For most Government procurements Electric Boat appears to place great reliance on an elaborate, computerized "cost avoidance" reporting system to justify prices being paid. They report as "savings" any favorable differences between budgeted and final prices paid. However, flexibility in establishing the budget amount makes this system of almost no value in determining the reasonableness of prices being paid.

A substantial improvement could be made in Electric Boat procurement practices under Government contracts if Electric Boat simply applied the same controls to procurements involving Government funds that are applied to procurements involving corporate funds--in other words, if Electric Boat treated Government money with the same care as they do their own money.

B. Charging of Material and Labor Costs

1. Material Costs:

a. Electric Boat's material control system contains serious deficiencies such that the validity of material costs charged to Government contracts cannot be determined.

Electric Boat has a complex, computerized material control system. It involves separate but parallel record-keeping by the Cost Accounting Department and the Inventory Control Department.

In May 1967, the Resident Government Auditor found that Electric Boat's material control practices were inadequate for accumulating costs under Government contracts. Electric Boat promised corrective action. The Government, however, did not follow up promptly to insure that Electric Boat's corrective action was adequate.

A June 1969 General Dynamics Corporate Headquarters audit of Electric Boat's material control system disclosed further deficiencies. For example they found serious quantity and pricing errors in inventory charges. The report stated:

> "There are pricing and quantity discrepancies caused by a time lapse between inputs and material transfers. Transfers...are subsequently, sometimes as long as three months later, forwarded to Cost Accounting-Materials for pricing and input to the Cost Accounting System...Due to the absence of good input controls and the maintenance of two EDP systems to record the same activity, the division has, and to a lesser extent, continues to create its own quantity, price, and dollar variances...The large volume of accounting adjustments made to correct errors created by the system makes it difficult to follow an audit trail for reconcilation purposes."

During the first quarter of 1969 deficiencies in inventory control procedures necessitated accounting adjustments or corrections totaling $2.0 million on a $10 million inventory. Inventory accounting adjustments are continuing at about the same rate.

In summary, Electric Boat has not taken effective action to correct the deficiencies in its material control system even after the Government has pointed out the seriousness of this problem. The Government has not taken action to require Electric Boat to provide effective control over material costs.

b. Through questionable material charging practices, Electric Boat is charging the Government for material that remains in inventory and for material that Electric Boat itself has not paid for.

Electric Boat carries a $10 million inventory of materials commonly used in the performance of its contracts. Material in inventory should not be charged to the Government until the material is actually issued for use on Government contracts. However, Electric Boat charges the cost of its material inventory to Government contracts at the end of the month, as if the material had actually been issued. Electric Boat then receives progress payments on these "costs" even though the material physically remains in inventory.

On the first of the succeeding month Electric Boat reverses the charge so that the material again shows up as inventory on the accounting records. Under this arrangement the Government finances Electric Boat's $10 million inventory, interest-free, thus freeing up an equivalent amount of General Dynamics funds for other corporate purposes. I consider this of an improper charge to Government contracts.

Electric Boat has also arranged for special, expedited Government payments for material procured directly for use on Government contracts. Electric Boat bills the Government for such material or equipment upon receipt. The Government pays Electric Boat weekly, within 4 days after Electric Boat submits its bill. Thus Electric Boat can usually collect payment from the Government long before Electric Boat pays its suppliers.

Many of Electric Boat's suppliers are small companies. These small suppliers have their own funds tied up in material for which Electric Boat has already received payment from the Government. The Government should require Electric Boat to certify that its suppliers have been paid before Electric Boat can bill the Government for the costs of subcontracted work.

2. Labor Costs

a. Under the present labor charging system supervisors have a strong incentive to charge labor costs to the labor budget account that can best absorb the cost and not necessarily to the budget account for the work actually performed.

The present labor charging system is succeptable to mischarging of costs. Budgets are established by Electric Boat management . Supervisors are responsible for keeping within budgeted amounts. Supervisors are also responsible for determining how to charge the time worked by their employees. Because one measure of personnel performance is the ability to stay within budget and because, in general, supervisors are working on more than one budgeted job at a time, there is an incentive to charge direct labor based on which budget can best absorb the charge. In this way budget overruns can be minimized thereby improving performance ratings. This pressure on a supervisor to "charge to the budget" is illustrated by the following statement which is printed on a "Budgeted Man Hour Allocation" form given to supervisors:

> "NOTE: Man hours should be kept within this budget. If you have any questions call the following telephone number 3795." (The telephone number is for "Direct Labor Control".)

An Electric Boat memorandum discussing the labor budget reporting system indicates that Electric Boat management recognizes the ability of supervisors to mischarge costs. The memorandum stated:

> "(Name) and his Operations Management review these monthly Performance Reports and furnish Direct Labor Control with reasons for significant over and underruns to the detailed budgets. Direct Labor Control (Name) is well aware that mischarging may occur for various reasons or causes. However, every supervisor should be aware that mischarging works to the disadvantage of the trade and the division by distorting the true labor cost of the job as well as all of the actual hours charged against the trades total budget. Mischarging also results in improper budgets being imposed on subsequent contracts with its attendant lost time in tracking down variances from distorted historical mischarging."

Despite the succeptability of the labor charging system to mischarging no effective safeguards have been established in this area. This is discussed further in the following section.

b. A comprehensive review of Electric Boat labor charging practices has not been conducted. However, there are indications that labor costs are being mischarged. There are no effective controls to preclude such mischarging.

Electric Boat does not have an effective system of labor checks and other safeguards to protect against mischarging of labor costs. When asked for copies of internal Electric Boat audits of labor costs or other cost areas, the Electric Boat Comptroller replied that copies of internal audit reports were provided the Government auditor. The Government auditor said he did not get such reports. The reply to the Government auditor's formal request for copies of the reports indicates the extent of Electric Boat internal audits. The Electric Boat Comptroller said:

> "Insofar as Electric Boat Division is concerned, we do not have an Internal Audit Staff. You are aware, of course, that we do have an Audit Liaison Section whose primary duties are to maintain liaison with your office as well as other audit agencies. This Section does not perform formal internal audit assignments as set forth in CAI 63-4. Therefore, we are not in a position to comply with your request.
>
> If and when an Internal Audit Staff is established at Electric Boat Division, your office will be provided with copies of their reports in accordance with Corporate policy."

The Government has not conducted a comprehensive review of Electric Boat's labor charging practices. For each of the last 5 years, only about 13% of Electric Boat's departments have been reviewed by Government auditors. On this schedule, labor charging practices in any particular department is checked, on the average, once every 7-8 years.

Further, Government attempts effectively to review Electric Boat's labor charging practices, even in the areas where spot checks are conducted, have been thwarted by Electric Boat's refusal to provide pertinent labor budget records and reports for Government review. Electric Boat denies the Government access to such information on the basis that it is "management information" and not an accounting record, even though 98 percent of the work at Electric Boat is under Government contracts.

Although a comprehensive review of Electric Boat labor charging practices has not been made, there are several indications of mischarging. Some Electric Boat professional employees stated that they charge their work based on budget data provided by the company rather than on the work actually performed.

Recent spot checks by Government auditors revealed what seems to be serious mischarges of labor costs in two departments. The discrepancies in these departments involved charges to cost-type contracts for work that was paid for under fixed price contracts and direct charges for work that was of an indirect nature which should have been in overhead. Minor incorrect practices in charging labor costs were found in many of the departments checked.

Even though 98 percent of the work at Electric Boat is for the Government, mischarging of labor costs can result in overcharges to the Government. For example, if work for a fixed priced contract is mischarged to a cost-type contract, the Government would be paying twice for the same work--once in the price of the fixed priced contract and again as a reimbursable expense under the cost-type contract. In these circumstances, greater surveillance of Electric Boat's labor charging practices is needed both by Electric Boat management and by the Government.

C. Change Orders and Claims

1. Under the present system, there is no way to insure that the Government is not overcharged in the adjudication of changes or in the settlement of claims.

Electric Boat has about 75 personnel assigned to a change control group which identifies potential claims and follows their preparation and processing until such claims are submitted to the Government and settled. Because Electric Boat normally does not account separately for the cost of changed work, there is no factual record from which either Electric Boat or the Government can determine the actual cost of work that is the basis for the claim. Those charged with the responsibility for settling claims must rely mostly on "judgment" and independent estimates in arriving at a proper settlement. This is true even though the work is often accomplished long before the claim is settled. At one time, Electric Boat did account separately for the cost of changed work. However, that system was abandoned after a General Accounting Office (GAO) review indicated that 58 of the 110 change orders reviewed had been overpriced by about $269,000. Now, these costs generally are not separately recorded except when required by the Supervisor of Shipbuilding for work funded from different appropriations.

Under these circumstances, the Government must depend primarily on the contractor's estimates and his representation of the circumstances in settling claims. To refute the contractor's claim, or to challenge with any authority his cost estimate requires considerable time and effort. Historically there is a large backlog of claims and unadjudicated changes. These outstanding claims are sometimes grouped together and an overall settlement reached. Consequently, the Government cannot tell on a job-by-job basis how much Electric Boat really spent for the extra work claimed or what the Government paid for it.

There are indications of overcharges in claim settlements. For example, the GAO report on pricing of change orders at Electric Boat indicated that the Government had been overcharged in more than half the cases reviewed. More recently, Government Auditors at Electric Boat found that Electric Boat had overcharged the Government in calibrating certain equipment used in submarine overhauls. The cost records indicated that the Government had been overcharged about $90,000 on $200,000 worth of change orders for identical work. Further, $58,000 of the $90,000 represented duplicate charges for work which the Government had previously paid for under earlier contracts. Additional safeguards are needed to insure reasonable and equitable claim settlements for the Government.

2. Present procedures for handling claims against the Government for changed work seem to be heavily weighted in favor of the contractor.

Under the present system, the Government is at a substantial disadvantage in negotiation and settling claims for changed work. As mentioned in the preceding section, the Government cannot rely on contractor accounting records to determine the cost of changes made and there is now no way to determine whether or not the Government is being overcharged on claims settlements with Electric Boat. In addition the rules seem to favor the contractor in other respects. For example:

a. Electric Boat has a special 75 man group that works full time on documenting and prosecuting claims. This group has unlimited access to technical, legal and contract specialists within the company who actually prepare the claims. The cost of this group is prorated to each claim and paid for by the Government as a direct charge in claim settlements. In contrast, the Supervisor of Shipbuilding has about 10 people, none of whom are lawyers, assigned full time to settling changes and claims made by Electric Boat. The Government does not have a special fact-finding group to document in detail the Government's and Electric Boat's performance during shipbuilding contracts. Thus under present procedures, the Government pays for at least 75 Electric Boat employees who work full time prosecuting claims against the Government. The Government, however, employs only 10 people to defend against such claims.

b. Electric Boat can prosecute claims against the Government at any time prior to final contract closeout which often is years after all work has been completed. For example, contracts for Polaris submarines delivered to the Navy from 1960 through 1964 have not yet been closed and change order claims for work on these ships are just now, in 1969, being settled. Most other contracts for submarines delivered since 1964 are still open. Thus while Electric Boat has years to submit and prosecute claims against the Government, the Government's right to submit a claim against Electric Boat for defective work is limited to six months after ship completion.

The magnitude of the problem can be illustrated by a statement made by the Government representative responsible for settling claims. He said that under Naval Ship Systems Command procedures he had unlimited authority to settle claims in Electric Boat's favor but that procedures for denying claims were so complex and time consuming that he was effectively precluded from denying a claim.

c. Electric Boat can submit claims up to $100,000 without even certifying that the information is correct and that prior payment has not been received for the work in question.

Present procedures need to be strengthened so as to put Government representatives on more equal footing with the contractor in settling claims.

D. Government Surveillance of Operations at Electric Boat

The Government's procedures and practices in administering the work performed by Electric Boat under Navy contracts are inadequate. In view of the numerous purchasing deficiencies cited earlier in this report it is apparent that Government representatives place undue reliance on Electric Boat's procurement system to obtain reasonable prices for the Government. Electric Boat procurements are for the most part free from Government surveillance. Government representatives do not have access to certain key financial reports of Electric Boat that are essential in determining the reasonableness of charges to Government contracts.

Government representatives are not reviewing the company's "Make or Buy" decisions. In such decisions, determinations are made as to whether it would be more economical to perform work in-house or to subcontract it. There are indications that Electric Boat "Make or Buy" decisions are not always made with the interests of the Government foremost.

The Supervisor of Shipbuilding does not review Electric Boat's procurements from other divisions of General Dynamics Corporation. The contractor does not have to justify the cost of these procurements or to indicate whether or not these items are being obtained at less cost than could be obtained from other companies. The Supervisor of Shipbuilding does not adequately review major areas of cost at Electric Boat considering that the Government ultimately pays at least 98 percent of these costs. Finally, a number of former Electric Boat employees are now employed by the Government in positions where they are responsible for surveillance of contractor operations in the areas where they formerly worked. This practice is not conducive to proper business relationships.

1. Government representatives place undue reliance on Electric Boat's procurement system to obtain reasonable prices for the Government.

For the most part, the Government relies on Electric Boat's procurement system to obtain reasonable prices under Government contracts. Under the terms of Navy cost-type and incentive contracts with Electric Boat, the Government has the right to review and approve major subcontracts (generally those over $25,000 in value) prior to placement to determine if the pricing is reasonable. However, the Supervisor of Shipbuilding has waived this right based on the following recommendation from a NAVSHIPS Contractor Procurement System Review Team in June 1968:

> "The Contractor's procurement system affords the maximum protection of the Government's interest and assumes procurement of materials at the lowest prices consistent with quality and required delivery schedules."
>
> "It is recommended that the Contractor's purchase system be approved without limitation, and no purchase orders be submitted for approval, other than such approvals as may be required by non-standard contract clauses..."

The Review Team spent three days reviewing the contractor's procurement system. Government representatives and Electric Boat personnel stated this was the first Government review ever conducted of Electric Boat procurement practices and that no subsequent review has been made. On October 2, 1968, the Supervisor of Shipbuilding officially approved Electric Boat's procurement system. The approval letter concluded:

> "You are to be commended that your procurement system merits Government approval, and you are urged to continue your efforts to maintain an acceptable procurement system."

In addition to not reviewing and approving individual procurements, the Supervisor does not have a regular program to review in detail individual procurement files on a spot-check basis. Several Electric Boat personnel stated that, except for the 3 day Government procurement review in June, 1968, I was the first Government representative to review Electric Boat procurement by studying their files.

Electric Boat appears to do a better job of procurement when they are required to submit procurements for approval. For example, files relating to procurements made by Electric Boat for the British Navy indicate that the local British representative reviews and approves procurements over $10,000 and requires special justification and certification by Electric Boat management for prices in excess of $100,000. The files indicate that Electric Boat management paid much more attention to these procurements than it did to comparable procurements for the U. S. Government.

2. Although Government business accounts for 98 percent of the work at Electric Boat, Government auditors do not have access to certain Electric Boat financial reports that are essential in determining the reasonableness of charges to Government contracts.

As previously indicated in this report, Electric Boat has refused to provide labor budget reports and other relevant financial records and reports to the Government. A Material Salvage Financial Report exists that shows which contracts are credited with the proceeds of sales of salvage materials amounting to about $9 million each year. Electric Boat refused to provide me a copy of the report. The Government auditor's files indicate numerous problems in gaining access to Electric Boat records. Further, the Government Auditor and the Contracting Officer for the Supervisor of Shipbuilding stated that Electric Boat screens certain files and other records before they are made available to Government representatives who request them for audit and review purposes.

3. Government representatives do not review the company's "Make or Buy" decisions and there are indications that such decisions are not always made with the interests of the Government foremost.

Decisions which determine whether items will be made in-house or will be bought by subcontract can greatly effect the cost of Government work. However, such decisions are not reviewed by the Government as required by the Armed Services Procurement Regulation. In one case senior Electric Boat personnel recommended that Electric Boat perform certain valve refurbishment work now being done by a subcontractor, Vickers, Inc. Since a number of Navy submarines will require this work to be done in future, this proposal was sent to the Make or Buy Committee. The Committee noted that this work could be done by Electric Boat at a total cost to the Government of about $23,000 less per ship than the $63,000 charged by Vickers. The Committee nonetheless rejected the recommendation. The minutes of the meeting stated:

> "...the real saving (to Electric Boat) would be in the neighborhood of $4,000 per ship, not $23,000, after considering the mechanics of fee arrangements on the contract. This fact, coupled with the risk involved in not being able to produce due to possible material problems, the need to maintain a parts inventory, and inventory control problems, the committee voted 6 to 3 to continue to buy from Vickers".

4. The Supervisor of Shipbuilding does not review Electric Boat procurements from other divisions of General Dynamics Corporation. The contractor does not justify the cost of these procurements or indicate whether or not these items are being obtained at less cost than would be possible from other companies.

Procurement files do not explain or justify these procurements. Decisions to award work to other General Dynamics divisions seem to be made outside of the Procurement Department. Files do not indicate whether these items could be obtained at less cost from other companies. The Supervisor of Shipbuilding does not review these transactions nor is he formally notified of them.

The Procurement System Review Team in June 1968 recommended that all orders placed with other divisions of General Dynamics be treated as purchases subject to standard practices and procedures. This has not been done.

There has been no verification that some charges for work by other Divisions of General Dynamics are reasonable and proper. For example, in March, 1969, Electric Boat placed cost-type procurements for ball valves valued at $2.5 million with the Canadair Division of General Dynamics in Montreal, Canada. No justification for the estimated costs was given and the files indicate that no effort was made to verify the reasonableness of estimated costs for this work. After being questioned about this, the local Government auditor has taken steps to have Canadair costs audited by Canadian Government auditors.

In addition to work Electric Boat assigns directly to other divisions of General Dynamics, there is other Electric Boat work that ends up at other divisions of General Dynamics via Electric Boat's suppliers. For example, Electric Boat regularly buys pumps from Ingersoll-Rand which in turn subcontracts the pump motors to Electro-Dynamics, another Division of General Dynamics -- the primary supplier of quiet motors for the Navy. Although these are non-competitive procurements, Electric Boat procurement files indicate that no cost breakdowns have been obtained from Electro-Dynamics and no cost analysis of the prices paid has been performed. Electro-Dynamics has refused to provide cost breakdowns and, since its prices are typically just under the $100,000 cut off point specified in the Truth-in-Negotiations Act, no one has made an issue out of Electro-Dynamics refusals. Since the costs and profits of Electro-Dynamics are amplified by the succeeding overhead and profit markups of Ingersoll-Rand and Electric Boat before being passed on to the Government as a cost, a detailed analysis of Electro-Dynamics procurements should be carried out.

5. The Supervisor of Shipbuilding does not adequately review major areas of cost at Electric Boat considering that the Government ultimately pays at least 98 percent of these costs.

The Supervisor seems to be dealing with Electric Boat as if it were a predominatly commercial firm engaged in a highly competitive business where competition alone provides sufficient incentive for economical operations. The Government's review of Electric Boat's business transactions appear superficial. As a result, Government representatives do not seem to have much awareness of what is really going on at Electric Boat. As mentioned elsewhere in this report, Government representatives apparently have not been aware of serious deficiencies in Electric Boat's procurement practices, comprehensive reviews of labor charging practices have not been conducted, and only recently, were efforts being made to see if known deficiencies in Electric Boat's material control system have been corrected. Government representatives had not looked into Electric Boats "Make or Buy" decisions, did not have access to pertinent labor budget records, and did not review subcontracts to other General Dynamics divisions. Although I did not specifically review in detail Electric Boat overhead charging practices, I found that Electric Boat is charging the development costs of a commercial Artic submarine tanker to their local overhead costs, 98 percent of which are paid for by the Government under Navy contracts. One million dollars has been budgeted for this project to date. The Navy should not have to pay for the development of a commercial submarine.

6. A number of former Electric Boat employees are working in the offices of the Supervisor of Shipbuilding and the Government auditor. This situation is not conducive to proper business relationships between the Government and Electric Boat.

A number of former Electric Boat employees have been hired by the Resident Government Auditor and by the Supervisor of Shipbuilding in positions where they are responsible for contractor surveillance. While I have no reason to suspect any impropriety on the part of these employees, the situation is not conducive to proper and objective relationships between the Government and Electric Boat.

Recently, the Supervisor of Shipbuilding was advised by the Naval Material Command that a former Electric Boat employee, now working within the Naval Material Command, had been selected by the Navy to head a Navy Procurement Review Group assigned to conduct the annual review of Electric

Boat's procurement system this fall. The Supervisor of Shipbuilding has objected officially to the proposed assignment.

A much better policy for the Government to follow would be to avoid placing former contractor employees in positions where they are responsible for surveillance of the same plant where they formerly worked.

7. There are indications of some recent improvement in Government surveillance of Electric Boat. However, the Government must take much stronger action to correct the fundamental deficiencies at Electric Boat.

Local Government representatives are looking into a number of issues about which I have questioned them. For example:

a. In the area of labor and material charging practices, the Resident Government Auditor has asked Electric Boat for copies of Electric Boat internal audit reports. The auditor has also requested access to specific Electric Boat labor budget records. He appears to be making many more spot checks of how Electric Boat employees are charging labor costs. These are steps in the right direction; however, these actions alone will not correct the problems at Electric Boat. The Government should withdraw approval of Electric Boat's accounting system until Electric Boat institutes effective controls that will preclude mischarging of labor and material costs to Government contracts. The Government should conduct a comprehensive review of Electric Boat's practices in charging labor, material and overhead costs.

b. In the area of procurement, the Supervisor of Shipbuilding recently rejected several Electric Boat procurement recommendations because the price justifications were inadequate. This was rarely done before. The Supervisor of Shipbuilding is now planning to issue instructions to his people on how to review Electric Boat procurements. Also, I understand that the Supervisor of Shipbuilding has complained to Electric Boat Management about the quality of Electric Boat procurements.

I do not think this action alone will be sufficient to obtain the needed improvements. The procurement deficiencies at Electric Boat are fundamental. These deficiencies have persisted so long that they have become the normal way of doing business. To bring about the necessary changes, Electric Boat Management will have to completely overhaul its procurement practices. They will have to undertake a comprehensive reeducation and retraining program to change prevailing attitudes. Electric Boat Management should be required to apply as much attention to the expenditure of Government funds as they do to the expenditure of corporate funds. Meanwhile the Government should require Electric Boat to submit all subcontracts in excess of $25,000 for Government review and approval prior to placement.

c. The Resident Government Auditor is now investigating the $2.5 million, ball valve procurement from Canadair Division of General Dynamics Corporation. However, the Government should conduct a thorough review of Electric Boat transactions with other divisions of General Dynamics Corporation and establish formal procedures for reviewing such transactions to insure that the Government's interests are protected.

E. Profits and Contractor Investment

Corporate profit and loss statements indicate that in 1968 Electric Boat operations were conducted at a loss. These financial statements reflect company representations and have not been audited by the Government.

In pricing contracts with Electric Boat, the Navy, on the average, pays Electric Boat a 10 percent profit on costs. Assuming no cost overruns or underruns, a 10 percent profit would yield profits of about $22.5 million in 1967 and about $17.8 million in 1968. Such profits would provide General Dynamics a return on invested capital of about 30 percent and 35 percent for 1967 and 1968 respectively. As a return on net fixed assets, the return would be about 71 percent and 80 percent for the years in question. These are only rough calculations but they are indicative of the profit potential of existing Navy contracts with Electric Boat.

The following table summarizes the pertinent information:

Projected Return on Investment Resulting
From a 10% Profit on Government Contracts
With Electric Boat

	Costs Billed to the Government (millions)	Invested Capital (millions)	Net fixed Assets (millions)	10% Profit (millions)	Potential Annual Return on Investment	
					Invested Capital	Net Fixed Assets
1968	$178	$50.3	$25	$17.8	35.6%	71%
1967	$225	$75.5	$28	$22.5	30.0%	80%

From this information it appears that Navy contracts offer Electric Boat ample opportunity to realize a substantial return on the corporation's investment, and that the contractor's investment should be a major factor in establishing the rate of profit in Government contracts at Electric Boat. Instead the Navy calculates profits as a percentage of costs. Higher costs result in higher profits. Thus Electric Boat has a "negative" incentive to reduce costs.

Since the most common measure of profitability is return on investment, General Dynamics has no incentive to invest capital to reduce costs. If General Dynamics increases investment and profit stays the same, the return on investment is lowered. If the increased investment results in lowered costs, profit may go down and the return on investment is further lowered. Thus the overriding incentive is to maintain minimum investment with the highest obtainable cost basis for profit. In recent years, Electric Boat has been very effective in reducing the amount of General Dynamics funds required to operate Electric Boat. The preceding table shows that invested capital declined by 33 percent from 1967 to 1968.

Since 1963 the Navy has substantially increased the rate of profit paid in pricing contracts with Electric Boat-from about 7% in 1963 for cost type contracts to about 10% in 1969. Thus the Navy has paid a higher rate of profit on its contracts at Electric Boat at the same time that General Dynamics has reduced its investment in Electric Boat, by over a third.

There is almost no true competition -without which costs will not be kept down-in the shipbuilding industry. Electric Boat, a typical shipbuilder, has little incentive to cut costs. This highlights the need for frequent and effective Government surveillance of Electric Boat operations.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20350

IN REPLY REFER TO
08H-1394
23 October 1969

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Need for Improved Procurement and Cost Control Practices in the Construction of Naval Ships

Ref: (a) NAVSHIPS ltr Ser 08H-1337 dtd 30 April 1969
(b) SHIPS 08 memo Ser 08H-01354 dtd 23 September 1969
(c) COMNAVSHIPS memo dtd 6 October 1969

1. In reference (a) I forwarded to you a report which identified major deficiencies in procurement practices and cost controls at Newport News Shipbuilding and Dry Dock Company. I pointed out that these deficiencies were responsible for wasting millions of dollars each year, and that this would continue unless the Navy took prompt and adequate corrective actions. In reference (b) I sent you a follow-up report indicating additional problems discovered in this area; I pointed out that nothing has yet been done to correct deficient procurement practices and cost controls at Newport News, as reported in reference (a).

2. Reference (c) is your reply to my memoranda. In it you state that NAVSHIPS' review of these matters has not yet been completed, but that you will advise me shortly of your decision with respect to my recommendations. You further state that "we must ensure that the cure is not more costly than the cost risk of similar deficiencies occurring in the future, that the corrective actions we require of Newport News do not place them in a less competitive position for competitive fixed-price procurements, and that the corrective actions are practical and obtainable and do not generate misleading data."

3. I do not consider that "cure" of the issues I raised will be "more costly than the cost risk of similar deficiencies occurring in the future..." The Navy should know what it pays for; know what ships actually cost to build; have effective control over ship construction costs; see to it that shipbuilders follow economical and required procurement practices. Without these features, competent and economical management of our shipbuilding program cannot exist.

4. Further, I do not understand the significance of your comment "we must ensure...that the corrective actions we require of Newport News do not place them in a less competitive position for competitive, fixed price procurements." From what I have observed over many years there is little, if any, real competition in the naval shipbuilding industry. Newport News presently is the sole source for the nuclear aircraft carrier program; the nuclear frigate program; the high speed submarine program. They have also received a number of sole source ship overhaul and conversion contracts. Even in the SSN 637 class construction program--where several shipbuilders bid on the same

contract--the competition did not, to my mind, assure reasonable prices.

5. For many years Navy shipbuilders have been sheltered from competition, by the geographic factors in earlier years, or by factors such as workload, design, or schedular considerations as is now the case. In effect, the Navy's major shipbuilders can count on sufficient sole-source or cost-plus contracts to support them regardless of their efficiency or their ability to control costs. The Department of Defense policy of calculating profits as a percentage of cost, rather than as a return on investment, serves to reward higher costs in the industry with higher profits.

6. The Navy must face up to the fact that there is little, if any, true competition in the shipbuilding industry and that, as a direct result, the industry is neither efficient nor economical. Further, it has little incentive to become efficient or economic under existing Navy contracting and contract administration policies and procedures.

7. If the steadily rising cost of ships is to be halted, the Navy must take corrective actions that are, in your words, "practical and obtainable and do not generate misleading data." We must, in addition, require adequate Government surveillance of shipbuilder operations. Such surveillance has been proved to be ineffective at all major shipyards. For this reason I do not understand your concern expressed in reference (a) about unfair competitive advantage.

8. The current situation in shipbuilding is urgent and serious. Improper procurement practices and inadequate cost controls have increased and continue every day to increase costs on Government contracts. The Navy cannot afford to treat these gross deficiencies lightly or to invoke delay in their correction. I consider it inappropriate under the circumstances--particularly with the present Congressional displeasure at inefficient Defense procurement practices--to procrastinate further.

H. G. Rickover

H. G. Rickover

CC:
CNM
ASN (I&L)

NAVSO 5216/9 (REV. 11-67)
S/N-0104-004-1705 (REV. 11-67)
DEPARTMENT OF THE NAVY

Memorandum

00:NS:mp
Ser 85

DATE: 1 Dec. 1969

FROM : SHIPS 00

TO : SHIPS 08

SUBJ : Control of Construction Costs at Newport News Shipbuilding and Dry Dock Company

REF : (a) Deputy Commander for Nuclear Propulsion Memo to Commander, Naval Ship Systems Command Ser 08H-01354 of 23 Sep 1969 (C)
(b) Deputy Commander for Nuclear Propulsion Memo to Commander, Naval Ship Systems Command Ser 08H-1394 of 23 Oct 1969
(c) Deputy Commander for Nuclear Propulsion Memo to ASN(I&L) Ser 08H-1337 of 30 Apr 1969

ENCL : (1) NAVSHIPS ltr 0763 Ser 334 of 24 November 1969 to ASN(I&L) (FOUO)

1. Enclosure (1) constitutes my action on references (a) and (b) and my comment on reference (c).

N Sonenshein

N. Sonenshein

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
0763:JF:dsr
Ser 334

24 November 1969

From: Commander, Naval Ship Systems Command
To: Assistant Secretary of the Navy (Installations and Logistics)
Via: Chief of Naval Material

Subj: Control of Construction Costs at Newport News Shipbuilding and Dry Dock Company

Ref: (a) Deputy Commander for Nuclear Propulsion Memo to ASN(I&L) 08H Ser 1337 of 30 April 1969
(b) Deputy Commander for Nuclear Propulsion Confidential Memo to Commander, Naval Ship Systems Command Ser 08H-01354 of 23 September 1969
(c) Deputy Commander for Nuclear Propulsion Memo to Commander Naval Ship Systems Command Ser 08H-1394 of 23 October 1969

Encl: (1) Newport News Shipbuilding and Dry Dock Company ltr of 6 Aug 1969
(2) Resident DCAA Memo of May 21, 1969
(3) NAVSHIPS Review of Newport News Cost Control System
(4) NAVSHIPS Review of Subcontracting
(5) NAVSHIPS Review of a Cost System for Individual Changes
(6) NAVSHIPS Review of Internal Auditing Requirements
(7) NAVSHIPS Review of Recommendation for Certification of Claims by Contractor
(8) NAVSHIPS Recapitulation of Planned action items

1. References (a), (b), and (c) reported deficiencies in procurement, pricing, and cost control practices of the Newport News Shipbuilding and Dry Dock Company and recommended early corrective action. I have reviewed in depth the matters reported by the references. This review has been supplemented by analyses conducted by SUPSHIP Newport News and the Resident DCAA at Newport News. My conclusions and planned action are presented in this letter.

2. In pointing up their criticism of procurement, pricing, cost control, and general management practices of the NNS&DD Co., references (a) and (b) cited numerous specific deficiencies. These are discussed in enclosures (1) and (2), from which it appears that there is considerable disagreement on details of the reported items. But our reviews developed four basic procedures which merit careful study; viz., cost control, subcontracting, costing of contract changes, and internal audits.

3. Cost Control.

a. The first basic issue raised by references (a) and (b) is that of requiring the Company to establish an effective cost control system, including effective procedures to ensure that charges for naval ship construction are valid and accurate. As developed in enclosure (3), it is considered that Newport News has a reasonably good basic cost control system. The present system can be and should be improved to provide management with a basis for ascertaining the present status of work and to permit more accurate projection of cost overruns/underruns. Such improvements can be made without the disruption attendant to establishing a new system. Further, the improvements would be compatible with the Company's present budgeting and estimating systems. The suggested improvements are detailed in enclosure (3), and the Company has agreed to adopt them.

b. DODINST 7000.2 of 22 December 1967 provides the basis of a contractual requirement for a Performance Measurement System which includes cost control and budgeting. It is understood that NAVMAT is in the process of preparing a NAVMAT Instruction and an implementation manual for the DOD Instruction in order to establish standards for uniform management requirements and for NAVMAT overview of benefits obtained from such a contractual requirement. DOD has not yet promulgated the Guide for Performance Measurement described in the DOD Instruction. Pending receipt of the NAVMAT Instruction and Manual for the implementation of DODINST 7000.2, NAVSHIPS will:

(1) Obtain a monthly copy of the Newport News cost control reports for existing new construction contracts. Such a report is a good management tool to use for evaluating the likelihood of cost overruns, effectiveness of labor, validity of projected delivery dates and for progress payment computation purposes.

(2) Require SUPSHIP to monitor and expedite, with assistance of DCAA, the efforts of Newport News to improve as soon as possible the present system as delineated by NAVSHIPS.

c. References (a) and (b) also recommend the establishment of an effective system for insuring that charges are valid and accurate. NAVSHIPS, SUPSHIP and the Resident DCAA office consider that such a system does exist. It is true that erroneous charges to a contract have been made on occasion; however, this is not necessarily the fault of the system. What has occurred is that charges have been made to an improper cost class of a contract, even though such charges were properly incurred for work required by the contract. While such charges are valid as a proper charge to the contract, they do tend to warp the historical base for future estimating of cost classes. NAVSHIPS will request the Resident DCAA to conduct an intensified program of monitoring the timekeeping system, which is one of the responsibilities assigned to DCAA. Further, the Company has advised that it is employing additional internal auditors, who will assist in auditing the timekeeping system. SUPSHIP will be required to obtain from the Resident DCAA the results of such reviews and to report corrective actions taken. If no reviews are performed, SUPSHIP will so report; and NAVSHIPS will take appropriate action.. This matter of erroneous charges to a cost class under a contract, although it is a valid charge to the contract, has been a perennial problem in public as well as privately owned yards. Greater surveillance will reduce its incidence but will not eliminate it. At Newport News, an incentive system provides motivation to the employee who is on incentive work to insure that he is properly charged.

4. Subcontracting. The second basic issue concerns subcontracting. The question here is what level of subcontract procurement performance should be expected from a contractor under a contract containing the Consent to Subcontract Clause. We expect a prime contractor to perform all of the functions in the subcontract procurement that the Government would perform if it were awarding a contract in excess of $100,000. As outlined in enclosure (4), there is a difference between what the Government expects and what the contract clauses specified by ASPR require. NAVSHIPS will recommend to the ASPR Committee requirements which would incorporate our expectations into contractual requirements. Nevertheless, NAVSHIPS and SUPSHIP are proceeding to require improvements in the Company's procurement system on the basis of what we expect of a contractor. In the meantime, SUPSHIP approval of the contractor's procurement system has been withdrawn, and all applicable subcontracts will require consent when a contract contains the Subcontract Clause. Such a clause is a part of all recent contracts awarded to Newport News, and requires consent notwithstanding approval of the contractor's procurement system.

5. Costing of Contract Changes. The third basic issue is whether the contractor can or should have a system to maintain costs for individual changes. Enclosure (5) provides the rationale why such a system is not considered feasible except for the cost of special material which is procured for a change or in other very limited circumstances. This matter has been raised many times in the past. The NAVSHIPS position that such a system is not feasible is still held to be valid. If there is still doubt on this point, a task group of knowledgeable people, including industry personnel, should be convened to review this question and submit recommendations. This task group would make a feasibility study, including the cost effectiveness of such a system. If considered feasible, a pilot program could then be instituted to test it. Further, this basic issue is also involved in the proposal of paragraph 6c of reference (b) for certification by the contractor for each change order claim, regardless of amount, that costs claimed do not exceed the actual cost of the work performed. The NAVSHIPS position as detailed in enclosure (7), is that this is not necessary in the light of reviews otherwise required.

6. Internal Audits. The fourth basic issue concerns the duties of an ACO (SUPSHIP) and the internal audits to be performed by the contractor. In paragraph 5d of reference (a), the recommendation is made that the Navy should require Newport News to establish an effective program of internal reviews and appraisals of its operations. The Company has advised that it is expanding its internal auditing staff to 12 people from the present complement of 9. NAVSHIPS and SUPSHIP will work with the Resident DCAA to ascertain what should be required of the Company in this area and whether this augmented staff is performing internal reviews and appraisals of the operations of the Company in accordance with Navy requirements. Further action will depend on our findings in this area. DCAA is involved since such system reviews are a matter under its cognizance. DCAA is required to alert the ACO (SUPSHIP) when the contractor's performance in this area is unsatisfactory. As to the duties of the ACO (SUPSHIP), the recommendation contained in paragraph 5d of reference (a) would require SUPSHIP to review and monitor the internal review program and to establish an independent program of appraisals of Newport News operations. Pursuant to Chapter 3 of the Contract Audit Manual, DCAA is responsible for establishing an audit program and plan and for reviewing the following in the area of the effectiveness of the contractor's management control over costs:

a. Estimating System

b. Timekeeping

c. Cost Controls

d. Internal Controls

e. Budgeting

f. Contract Financial Management

g. Production Scheduling and Control, as it pertains to costs.

Although the above reviews are the responsibility of DCAA, NAVSHIPS does consider that SUPSHIP should insure that they are performed. SUPSHIP is working with the Resident DCAA Office to intensify such reviews. He will provide technical support to the auditors and will keep NAVSHIPS informed of the results. Upon receipt of advice from DCAA that the contractor should take corrective action, SUPSHIP will arrange with the Company to take such action promptly. Thus, what references (a) and (b) would require of SUPSHIP in the area of internal audits is a responsibility of DCAA. In the matter of production scheduling, SUPSHIP has a responsibility to review this system from a technical viewpoint and to assist the auditor in the performance of the review required by the Manual. Supplementary comments are contained in enclosure (6).

0763:JF:dar
Ser 334

8. A recapitulation of the planned actions on the part of the Government as well as the Company as developed in enclosures (3) through (7) is made in enclosure (8).

9. In summary, then, references (a), (b) and (c) have served a valuable purpose in highlighting the need for certain corrective measures. Improvements are not only desirable but clearly necessary, and a plan for accomplishment has been developed. The Newport News Shipbuilding and Dry Dock Company is undergoing rapid management changes, both in personnel and in practices; the new management is receptive to suggestions for improving operating procedures. The Company has established active management task groups and employed outside consultants. We will require the necessary improvements as a proper demand under the practices of flexibly-priced contracting, and I will keep you apprised of status and progress on a quarterly basis.

N Sonenshein
N. SONENSHEIN

Copy to:
02
02C
022
07Y(ES)
076
08
SUPSHIP NPTNWS
Res. DCAA NPTNWS

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

08H-6403
23 December 1969

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Deficiencies in Procurement of Hull Steel by Newport News Shipbuilding and Dry Dock Company

Ref: (a) NAVSHIPS ltr 0763:JF:dsr Ser 334 of 24 November 1969
(b) VADM Rickover memorandum Ser 08H-1337 of 30 April 1969
(c) VADM Rickover memorandum Ser 08H-01354 of 23 September 1969

Encl: (1) Report of Practices Followed by Newport News Shipbuilding and Dry Dock Company in Procuring Hull Steel for Construction of CVAN68

1. Reference (a) identified the actions you intend to take with respect to deficiencies in shipyard cost control and procurement practices I described in references (b) and (c). You have asked for my comments on your proposed action plan.

2. I have not studied reference (a) sufficiently to provide you with detailed comments at this time. However, I will comment as soon as possible.

3. Recently, I found what appears to be a major problem in the procurement of hull steel by Newport News. Substantial amounts of HY 80 and HY 100 steel are required in the construction of CVAN68. The General Accounting Office in June 1965 issued a report to Congress criticizing the way the Navy and its shipbuilders procured HY 80 steel used in the construction of nuclear submarines. Therefore, I asked one of my representatives to review how Newport News currently procures this material. Enclosure (1) is the report I have received.

4. The General Accounting Office report stated that the Navy and its shipbuilders should obtain cost and pricing data from HY 80 steel suppliers in order to comply with the requirements of the Truth-in-Negotiations Act. The Navy agreed. Today, more than four years later, enclosure (1) indicates that Newport News is still not obtaining cost and pricing data from HY 80 and HY 100 steel suppliers.

5. Enclosure (1) also identifies specific problems in Newport News' procurement of high tensile steel. Apparently, the shipyard has bought about $3.4 million worth of high tensile steel from Bethlehem Steel Corporation without bothering to obtain competitive bids from other qualified firms and without obtaining or evaluating supplier cost and pricing data. Further,

Newport News has broken the $3.4 million total requirements from Bethlehem Steel Corporation into more than 1200 individual orders, such that apparently no individual high tensile steel order for CVAN68 exceeds $100,000--the lower limit for requiring cost and pricing data under the Truth-in-Negotiations Act. Through these practices, it appears to me that Newport News is not taking maximum advantage of its potential bargaining power to obtain hull steel at lower prices.

6. I am bringing this matter to your attention so that appropriate corrective action may be taken. In this regard I recommend that NAVSHIPS check the procurement of hull steel at other shipyards to ensure that deficiencies previously pointed out by the General Accounting Office have been corrected as promised by the Navy and to ensure that hull steel required in naval ship construction programs is being procured in the most economical manner.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material

ENCLOSURE (1)

Report of Practices Followed by Newport News Shipbuilding and Dry Dock Company in Procuring Hull Steel for Construction of CVAN68

I. Background

In 1965, the General Accounting Office (GAO) issued a report to Congress concerning procurement of HY 80 steel plate from U. S. Steel Corporation and Lukens Steel Company for use in the construction of Navy ships. The GAO report stated:

> "...neither the Navy nor its prime shipbuilding contractors had obtained and evaluated cost data for the purpose of determining the reasonableness of the identical mill prices charged by these two steel suppliers. These companies constituted the principal available sources of supply for this essential material which is used almost exclusively in the construction of nuclear submarines and other naval vessels. These cost data properly certified by the contractors, in our opinion, should have been required and considered by the Navy and its prime shipbuilders in the negotiation of prices under the Armed Services Procurement Regulation prior to December 1, 1962, and under Public Law 87-653 thereafter."

The GAO report explains that HY 80 steel plate is a specialized item produced in accordance with military specifications. It is produced principally by two steel makers, United States Steel Corporation and Lukens Steel Company. The firms quote identical catalog mill prices for this material. The GAO reported that, depending on the way the figures were presented, the rate of profit on costs for U. S. Steel varied from 3.5% to 14.5% and for Lukens from 22.9% to 26.8%. The GAO concluded that there are sufficient differences in the costs of producing HY 80 steel plate, and in the profits to be realized from identical prices, to require cost and pricing data from both manufacturers in any future negotiated procurements of HY 80 steel plate (or successor types) as required by the Truth-in-Negotiations Act.

The Navy agreed with the GAO findings. The following is quoted from the GAO report:

> "With regard to our first proposal, the Navy stated that procurement of HY 80 steel plate by formal advertising had been discontinued and that cost or pricing data was now being required and certifications were requested in accordance with the provisions of ASPR 3-807.3. In addition, the Navy stated that successor types of plate and other types of steel will be considered for similar treatment as conditions warrant.
>
> With regard to our second proposal, the Navy indicated that prime contractors had been advised to obtain cost or pricing data on all HY 80 steel-plate procurements and to obtain certifications in accordance with the provisions of their prime contracts."

II. Procurement of HY 80 and HY 100 Steel for CVAN68

In view of the GAO's findings, and because hull steel is a significant cost factor in Navy ships, a review was conducted of how HY 80 and HY 100 steel was being procured by Newport News for CVAN68. It appears that HY 80 and HY 100 steel plate is still being procured as described in the GAO report. The bids of both suppliers seem to be identical when transportation costs are considered, and certified cost or pricing data, as required by the Truth-in-Negotiations Act, are not being obtained.

Newport News procurements of HY 80 and HY 100 steel plate for CVAN68 total nearly $9 million--$3,650,000 to Lukens, $5,250,000 to U. S. Steel, and $5,000 to ARMCO Steel Company.

For each of the purchase orders reviewed, bids were solicited from both Lukens and U. S. Steel. In each case the Lukens bid was slightly higher than the price quoted by U. S. Steel. However, penciled notes in Newport News purchase files adjusted the two bids by adding the freight costs from each mill to Newport News. These adjustments made the bids identical. In several of the procurements reviewed, Lukens advised Newport News that they were raising their prices. Within 30 days, in each case, U. S. Steel increased their prices by an identical amount. Thus, the prices from these two independent suppliers remained identical. Newport News purchasing personnel stated that because the bids are identical after transportation costs are considered, award to Lukens or U. S. Steel is dependent upon "company policy." (In certain cases Newport News solicited bids from ARMCO as well as Lukens and U. S. Steel. However, the files state that ARMCO was non-responsive because of higher prices and because they were unable to supply all the items on order.)

III. Procurement of High Tensile Steel for CVAN68

In addition to HY 80 and HY 100 steel, Newport News has procured about $3.4 million worth of high tensile steel for use on CVAN68. A review of the shipyard's high tensile steel procurements revealed what appears to be two major deficiencies:

Failure to obtain competitive bids for high tensile steel requirements

Newport News is buying large quantities of high tensile steel plate on a sole-source basis, even though there is more than one supplier for this material. A review of these purchases indicates that Newport News has been awarding the purchase orders to Bethlehem Steel Company without soliciting bids from other vendors and without performing an evaluation as to the reasonableness of prices paid. Shipyard procurement personnel acknowledged this purchasing procedure, although they recognize that there are other vendors. They claim that procurement of high tensile steel from Bethlehem would always result in the lowest cost because of transportation considerations. The Bethlehem orders are shipped by barge from nearby Sparrows Point, Maryland.

It may be that the "catalogue prices" for high tensile steel are the same for all suppliers, and thus Newport News considers it unnecessary to solicit competitive bids. However, the shipyard's large requirements for steel could give it a strong bargaining point in a competitive situation. The potential for $3.4 million worth of orders might well induce one or more steel companies to quote below the standard price in order to win the business. At least, Newport News should allow all potential suppliers to bid. It does not appear that Newport News has made any effort to use its potential bargaining position to obtain lower prices for high tensile steel used on CVAN68 through competitive bids or negotiations.

Failure to obtain supplier cost and pricing data in sole source procurements

The Truth-in-Negotiations Act requires that prime contractors obtain and review subcontractor cost and pricing data in all noncompetitive procurements over $100,000. A review of purchase orders for high tensile steel revealed no evidence that cost or pricing data had been obtained and evaluated. Although the procurements of high tensile steel for CVAN68 totalled more than $3.4 million, Newport News had split them into more than 1200 separate purchase orders. No one purchase order exceeded $100,000. Shipyard procurement personnel claim that the major factor in determining the number of the Bethlehem purchase orders was the scheduling and size limitations of barge shipment. However, shipyard purchase records show that where the Truth-in-Negotiations Act does not apply, Newport News has placed high tensile steel orders in excess of $100,000. For example, on one commercial hull, the high tensile steel procurements totalled only $650,000. Two of these procurements were in excess of $100,000.

IV. Conclusions

Newport News has recently been awarded a contract to procure materials for CVAN69. Unless there is prompt action taken to correct the practices used by Newport News in the procurement of hull steel, the company's procurements of hull steel for the new carrier will probably be no better than those for CVAN68. Newport News should be required to solicit bids from all qualified sources and to obtain and review cost or pricing data in those cases where competitive bids are not obtained. The Navy should take action necessary to correct the deficiencies identified in the 1965 GAO report. It should also insure that its contractors establish effective purchasing procedures for other specialty steels used in ship construction.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
0763:JF:dar
Ser: 3

7 January 1970

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: Deficiencies in Procurement of Hull Steel by Newport News Shipbuilding and Dry Dock Company

Ref: (a) Deputy Commander for Nuclear Propulsion Memo 08H-64003 of 23 December 1969

1. Reference (a) reported a problem in the procurement of HY 80, HY 100 and high tensile steel by Newport News. In respect to HY 80 and HY 100 steel procurement, it was reported that the Company had not obtained cost or pricing data from the suppliers, even though GAO in a 1965 report had criticized the award of similar procurements without such data and the Navy had advised that shipbuilders would be required to obtain cost or pricing data from the suppliers. As to the high tensile steel, it was reported that the Company had procured the steel from Bethlehem Steel Corporation without competition and without obtaining cost or pricing data.

2. The basic facts reported in reference (a) have been verified by my review. However, there are other facts that bear on these matters which also must be considered in respect to these procurements. Most of these additional facts are available at Newport News Shipbuilding and Dry Dock Company and from the files at SUPSHIP Newport News. Among other things, they show that the SUPSHIP Contracting Officer consented to the placement of most of the purchases of HY 80, HY 100, and high tensile steel. If these procurements were improper, the SUPSHIP Contracting Officer must bear full responsibility for such impropriety. However, before the Contracting Officer is criticized for improperly consenting to the placement of these subcontracts, additional facts must be considered.

3. My review, to date, shows that in respect to the HY 80 and 100 steel procurements reported by reference (a), the Company is required to obtain the consent of the Contracting Officer for procurements in excess of $50,000. Certified cost or pricing data is required under PL 87-653 for subcontracts in excess of $100,000, unless the subcontract price is based on adequate price competition, established catalog or market prices of commercial items sold in substantial quantities to the general public, or prices set by law or regulation. Some HY 80 - 100 procurements were placed without consent because the Contractor's procurement system had been approved. After cancellation of the approval, the first request for consent to the placement

0763:JF:dsr
Ser: 3

of a HY 80 - 100 steel subcontract, in August 1968, was on the basis that the prices quoted by the suppliers were identical to those bid and accepted for the steel under a formally advertised procurement of the Defense Industrial Supply Center, Philadelphia (DISC) for Mare Island Naval Shipyard's new construction program. Notwithstanding this report, Newport News was advised to obtain cost or pricing data for the procurement. The response from both Lukens Steel Company and U. S. Steel was that DISC had been procuring HY 80 and HY 100 steel by formally advertised procurements since late in 1967 and that such procurements recognized that there was adequate price competition. They further advised that in view of the Government's determination of adequate price competition in the procurement of such steel, they would not provide cost or pricing data, since PL 87-653 does not require such data when a determination of adequate price competition is made. In view of the fact that DISC considered there was adequate price competition and the prices quoted were the same as those bid to the Government, the Contracting Officer consented to the procurement.

4. Further, my review of the HY 80 and HY 100 matter shows that since the 1965 GAO report:

a. Armco has increased its capacity for fabrication of such steel.

b. Bethlehem has become a supplier of such steel.

c. In August 1967, DSA in a memorandum to Deputy ASD (Procurement) advised that they were obtaining effective competition in the procurement of HY 80 steel "to such an extent that reasonableness of price is assured by that competition."

d. In October 1967, the Deputy ASD (Procurement), in responding to the DSA memorandum, advised that assuming the validity of the DSA conclusion (of effective price competition), it was not considered necessary to obtain GAO consent to buy this steel by formal advertising or by competitive negotiations.

e. In November 1967, DSA advised GAO that such steel was being procured under conditions of effective price competition and that they would formally advertise or competitively negotiate for HY 80 - 100 steel in the future.

5. It would appear that from a contract administration point of view, GAO should have been advised of the Navy's change in position, in that shipbuilders would not be required to obtain certified cost or pricing data because it was considered that there was effective price competition. It should be noted that Electric Boat is also procuring such steel on the basis of adequate price competition with the consent of the Contracting Officer. For future procurements of HY 80 - 100 steel, including requirements for CVA-69 placed by Newport News, I will review the competitive environment for

such procurements. If I determine that there is adequate price competition, I will advise GAO of that fact and of our intention not to obtain cost or pricing data from suppliers. If it is determined that there is inadequate price competition, certified cost or pricing data will be required as a prerequisite to consent to the placement of subcontracts. In the event that suppliers refuse to provide such data, the matter will be referred to the Secretary via NAVMAT in accordance with ASPR 3-807.6.

6. As to the high tensile steel, the granting of consent by the SUPSHIP' Contracting Officer was on the basis that the prices for these procurements were the most reasonable prices for the steel as delivered to the shipyard. This determination was predicated on the assumption that the prices at the mill are catalog prices and that the barge delivery cost from the Sparrows Point mill of Bethlehem was the lowest possible delivery charge. Thus, the delivered price was the lowest price possible. Newport News does not contend that the multiple orders were placed on the basis of barge loads, as stated in reference (a). The Contractor contends that such multiple orders were the natural outgrowth of working drawing preparation as related to the erection schedule for the ship and the leadtime for the steel. The contractor further contends that these multiple orders were placed with no intention of evading the requirements of PL 87-653. I am inclined to accept the position of Newport News, since catalog or market price of commercial items sold in substantial quantities to the general public is one of the exceptions to obtaining cost or pricing data required by PL 87-653; since consent is required at the $50,000 level, whereas the PL 87-653 threshold is in excess of $100,000; and since many of the orders required consent approval. Accordingly, any attempt by the Company to evade the requirements of PI 87-653 would have been ascertained during the consent process.

7. In any event, I consider that the matter of multiple orders and reasonableness of price needs to be resolved. To this end, I will direct SUPSHIP to:

a. Conduct a review of the relationship of drawing room output to the erection schedule and procurement/delivery lead time to ascertain if the orders could have been consolidated.

b. Require that for the CVA-69, orders be consolidated to the maximum extent possible.

c. Require that the solicitations be competitive to the maximum extent possible.

d. Consent to the placement of orders only after reasonable assurance of compliance with ASPR requirements and PL 87-653, as appropriate.

N Sonenshein
N. SONENSHEIN
Rear Admiral, USN
Commander, Naval Ship Systems Command

Copy to:
ASN(I&L)
CNM
SUPSHIP NPTNWS
SUPSHIP GROTON
SUPSHIP PASCAGOULA

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

08H-706
29 January 1970

MEMORANDUM FOR THE COMMANDER NAVAL SHIP SYSTEMS COMMAND

Subj: Deficiencies in Procurement of Hull Steel by Newport News Shipbuilding and Dry Dock Company

Ref: (a) Deputy Commander for Nuclear Propulsion Memorandum 08H 6403 dated 23 December 1969
(b) Commander NAVSHIPS Memorandum 0763:JF:dsr Ser: 3 dated 7 January 1970

1. In reference (a) I pointed out several major deficiencies in the way Newport News Shipbuilding and Dry Dock Company procures specialized HY 80 and HY 100 hull steel and other high tensile steels under Navy contracts. I pointed out that in 1965 the General Accounting Office found HY 80 steel contracts which had been awarded on the basis of prices quoted by the steel suppliers were resulting in profits of up to 26% on costs. From its review the GAO recommended and the Navy agreed that on subsequent procurements cost and pricing data would be obtained from HY 80 steel suppliers to assure that the quoted prices were reasonable in relation to the cost of producing this steel for the Navy. Recently, however, I found that Newport News is procuring HY 80 and HY 100 steel for the aircraft carriers CVAN 68 and 69 on the basis of quoted prices and without obtaining cost and pricing data to determine whether the prices being paid are reasonable.

2. In reference (a) I also pointed out that Newport News bought about $3.4 million worth of high tensile steel from the Bethlehem Steel Corporation for construction of the aircraft carrier CVAN68 without obtaining competitive bids from other qualified firms and without obtaining or evaluating Bethlehem's cost and pricing data. In buying this steel, Newport News placed more than 1200 individual orders with Bethlehem. None of these orders exceeded $100,000--the lower limit for obtaining cost and pricing data under the Truth-in-Negotiations Act. Thus it appears to me that Newport News is neither complying with the Truth-in-Negotiations Act nor taking maximum advantage of its potential bargaining power to obtain the lowest possible prices for this steel.

3. In reference (b) you verified the facts I reported in reference (a). In addition, reference (b) pointed out that:

a. The Supervisor of Shipbuilding, Newport News, reviewed and consented to some of the Newport News HY 80 and HY 100 steel orders prior to their placement.

b. In one case the Supervisor of Shipbuilding requested that cost and pricing data be obtained from HY 80 and HY 100 steel suppliers; the steel suppliers refused to provide such data. The Supervisor later consented to this order on the basis that the prices quoted by the suppliers were identical to those obtained and accepted by the Defense Industrial Supply Center for the same type steel under a formally advertised procurement.

c. Since late 1967, the Defense Industrial Supply Center has been procuring HY 80 and HY 100 steel without obtaining and evaluating supplier cost and pricing data on the basis that there is adequate price competition. The Deputy Assistant Secretary of Defense (Procurement) and the General Accounting Office were informed of this in 1967.

4. In reference (b) you also state that NAVSHIPS will review the procurement of HY 80 and HY 100 steel and that if competition is not considered adequate, NAVSHIPS will either obtain supplier cost and pricing data or request a waiver of the Truth-in-Negotiations Act. Reference (b) also indicates that the Supervisor of Shipbuilding will determine if Newport News orders are being consolidated whenever possible, and if maximum competition is being obtained.

5. I am well aware that large steel suppliers have been and continue to be reluctant to furnish cost and pricing data to the Government and that in some cases they have refused to do so. However, I do not believe the Government should be deterred from requiring cost and pricing data in cases where such data are required by the Truth-in-Negotiations Act. The Navy uses substantial quantities of HY 80 and HY 100 steel in its shipbuilding programs--$9 million has been spent to date for this material on the aircraft carrier CVAN 68 alone. Moreover, the Government has spent considerable sums to develop HY 80 and HY 100 steel. Although the Navy is the primary customer for this steel, it is my understanding that these procurements have been exempted from renegotiation under the Renegotiation Act. In these circumstances, I believe NAVSHIPS has a definite responsibility to insure that the prices it pays are reasonable.

6. The determination of adequate price competition is a difficult one. It has been my experience that far too often procurements have been classified as being competitive when the competition obtained at best was limited and of marginal effectiveness in holding prices to reasonable levels. In addition, much of our ship construction is contracted for on the basis of the shipbuilder's estimated costs. In such cases, higher costs can easily mean higher profits. Thus, there is often no real incentive or pressure from shipbuilders on suppliers to keep prices down. It also may be to a shipbuilder's advantage to buy in small quantities--even if this means paying higher prices--in order to minimize the funds required to perform Government contracts.

7. I recommend that NAVSHIPS find out whether the prices which have been and are being paid for HY 80 and HY 100 steel are reasonable. It appears that the 1965 General Accounting Office review is the only factual check that has ever been made on cost incurred and profits realized by HY 80 and HY 100 steel suppliers under Navy orders. I recommend that you arrange with the Defense Contract Audit Agency or, if necessary, the General Accounting Office itself to check actual cost records of the steel suppliers involved to determine what costs are being incurred and what profits are being made on contracts and subcontracts for HY 80 and HY 100 steel. I would further recommend that you take appropriate actions at all shipyards to insure that steel orders are consolidated and procured competitively to the maximum extent possible.

H. G. Rickover
H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
0763:JF:dsr
Ser: 35

5 March 1970

From: Commander, Naval Ship Systems Command
To: Chief of Naval Material (MAT 021)

Subj: Identical Catalog Price Bids for Steel for Ships Under Construction at Newport News Shipbuilding and Dry Dock Company

Ref: (a) Deputy Commander for Nuclear Propulsion Memo, 08H-64003 of 23 December 1969 to Commander, Naval Ship Systems Command Copy to CNM and ASN(I&L)
(b) Commander, Naval Ship Systems Command Memo, 0763 Ser: 3 of 7 January 1970 to Deputy Commander for Nuclear Propulsion Copy to CNM and ASN(I&L)
(c) Deputy Commander for Nuclear Propulsion Memo, 08H-706 of 29 January 1970 to Commander, Naval Ship Systems Command Copy to CNM and ASN(I&L)
(d) NAVSHIPS ltr Ser 0763-33 of 27 February 1970

Encl: (1) (SC) Samples of Purchase Orders
(2) Copies of Correspondence from U. S. Steel, Bethlehem Steel and Lukens Steel; refusal to provide data on commercial sales

1. Reference (a) advised that Newport News was buying large quantities of high tensile steel plate on a sole source basis from Bethlehem Steel Company for shipment by barge from the nearby Sparrows Point, Maryland mill. Newport News claimed that the delivered cost of the steel was lower than the delivered price from other suppliers and that they therefore did not obtain the bids of other suppliers.

2. Reference (b) advised that the consent granted by the SUPSHIP Contracting Officer was on the basis that all suppliers would bid identical FOB mill catalog prices and that when the cost of the barge delivery from the nearby Bethlehem Sparrows Point mill was added to the FOB mill prices, Bethlehem prices for the steel delivered to the shipyard would always be the lowest price. Reference (b) further advised that future solicitations for the steel would be competitive to the maximum extent possible.

3. Reference (c) recommended that appropriate action be taken to ensure that steel orders are procured with the maximum competition to the extent possible.

4. Subsequently, NAVSHIPS directed SUPSHIP to consent to the placement of steel orders only if they were placed as the result of maximum competition

and compliance with the requirements of PL 87-653, as appropriate.

5. Enclosure (1) is identical bids received by Newport News for steel. These bids are the catalog prices for the steel FOB the steel mills. When the shipment cost to the shipyard is added to the FOB mill prices, the delivered steel prices are different, and Bethlehem's price is the lowest price because of barge shipments from the nearby Sparrows Point mill. It is our understanding that the Defense Industrial Supply Center (DISC) Philadelphia also receives identical FOB mill prices in most instances. After taking the discount and adding the delivery cost, all prices are different and DISC makes the award to the supplier whose delivered price is the lowest. Cost or pricing data is not required.

6. In order to establish that cost or pricing data would not be required because the FOB mill prices were established catalog prices of commercial items sold in substantial quantities to the general public, Newport News requested the suppliers to advise the tonnage of steel sold to the general public. The suppliers refused to provide such information as evidenced by enclosure (2). NAVSHIPS has not required Newport News to obtain cost or pricing data from the steel suppliers, since a refusal to provide such data was inferred from the refusal to provide data from HY 80/100 steel, reference (d).

7. The steel involved is carbon steel under specification MIL-S-22698A e and carbon high tensile steel under MIL-S-16113C. It is probably that all of the suppliers do make substantial sales to the public on these types of steel or similar steels. However, as indicated in enclosure (2), this information was not furnished by the suppliers. Therefore, NAVSHIPS considers that the following alternatives are available:

a. The FOB mill price procurements are competitive, meet the requirements of ASPR 3-807.1(b)(1)(a), and there is no basis for considering the FOB mill prices as unreasonable. Therefore, consent can be granted on the basis of effective price competition without cost or pricing data.

b. Although the procurements are competitive, the identical FOB mill prices are considered unreasonable and cost or pricing data will be required when PL 87-653 is involved in the procurement. When PL 87-653 is not involved, consent will be granted only after Newport News conducts a price analysis of the bids received. This alternative recognizes that as the result of these requirements, the ships will be delayed and the schedule disrupted. NAVSHIPS has no basis for a determination that the prices are unreasonable.

c. Although the steel suppliers have refused to provide data on sales to the general public, the catalog prices do satisfy the requirements of ASPR 3-807.1(b)(2), which defines established catalog or market prices of commercial items sold in substantial quantities to the general public. Therefore, consent can be granted on that basis without cost or pricing data.

d. The delivered prices for the steel and not FOB mill prices are the only meaningful prices. Such prices are all different when the delivery costs are added to the FOB mill prices. Accordingly, the procurements satisfy the requirements of ASPR 3-807.1(b)(1)(a) and consent can be granted for the awards to be made to the supplier whose delivered prices are the lowest.

e. Consider that the prices bid by the suppliers do not reflect adequate price competition and that under the shipbuilding contract, Newport News is required to obtain cost or pricing data when the procurement is under PL 87-653 and to conduct a cost analysis of such data; insist that they obtain such data and perform the analysis. In the event that they make the procurement without such data and analysis, the determination of the shipbuilding contract final price would be dependent on a determination as to what the steel price would have been had they obtained the cost or pricing data from the steel suppliers and made the procurement after cost analysis of the data.

f. Consider that the prices bid by the suppliers do not reflect adequate price competition when PL 87-653 is not involved but consent required for steel procurements. Advise Newport News that the prices are not considered reasonable and to negotiate a reasonable price. If the procurements are placed without consent, the determination of the shipbuilding contract final price would be dependent on a determination as to what the steel prices would have been had they negotiated reasonable prices.

8. NAVSHIPS recommends that either NAVMAT consider that the delivered price of steel reflects adequate price competition and that the FOB mill prices can be considered to be catalog prices of items sold in substantial quantities to the general public or obtain a waiver of cost or pricing data.

9. Pending the receipt of a reply to this letter, consent to the placement of subcontracts for such steel is being withheld. The Contractor has advised that the delivery date on such steel procurements will be slipped if consent is not granted in the very near future and that this slippage will have an impact on cost and ship delivery schedules.

J. W. [illegible], Jr.
Deputy Commander for Field Activities/
Program Director for Shipyard
Modernization & Management

Copy to:
SHIPS 022
PMS 392
PMS 378
076
022(M)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-708
2 February 1970

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Shipbuilding and Overhaul Contracts with Ingalls; Request for Action Regarding

1. The purpose of this memorandum is to summarize the current unsatisfactory situation regarding shipbuilding and overhaul contracts with the Ingalls Shipbuilding Division, Litton Industries and to recommend that immediate corrective action be taken.

2. In June 1968, Ingalls was awarded a contract to construct SSN's 680, 682, and 683, three follow ships in the Fiscal Year 1967-8 SSN637 Class submarine program. Shortly thereafter, by mutual agreement of NAVSHIPS and Ingalls, actions were started to amend the contract to delay ship delivery dates by one year each and to adjust the contract price as necessary. This amendment was necessary to achieve the proper interval between the lead Fiscal Year 1967-8 SSN being constructed by Electric Boat Division and the SSN680 at Ingalls. Today, over a year and a half later, the contract amendment has not been executed by the NAVSHIPS Contracts Division. Further, I understand that Ingalls has recently withdrawn its proposal for the amendment and has informed NAVSHIPS informally that an additional five months delay in delivery of each ship is considered necessary, partially because of late government furnished hull steel. I also understand that Ingalls is preparing a new proposal for a contract amendment which will involve a considerable increase in contract price.

3. During 1968, several change orders for mandatory work were issued under the contract with Ingalls for completion of POGY (SSN647). The change orders were required to correct defective workmanship in POGY by the New York Shipbuilding Corporation. In the Spring of 1969, Ingalls proposed a revised contract delivery date for the ship of 31 December 1970. This proposal was not answered by the NAVSHIPS Contracts Division until January 1970, after pressure for a reply was brought to bear by PMS-381 and 08 representatives. In the meantime, because the ship contract delivery date was not agreed to, SUPSHIP, Pascagoula did not obtain price proposals from Ingalls for the change orders. The change orders have remained unpriced for over a year while the work involved has been completed. Further, I understand that Ingalls has now proposed a new contract delivery date for POGY of 1 March 1971 based on progress on the ship over the past year. Therefore, the whole process of establishing a firm contract delivery date for POGY and pricing outstanding change orders appears to be starting over again.

4. USS GUARDFISH is scheduled to start overhaul at Ingalls on 23 March 1970. This will be Ingalls' first overhaul of a nuclear powered ship. I understand that NAVSHIPS has agreed with Ingalls' request to delay the submission of their contract proposal for this overhaul until 13 February 1970, just 37 days prior to the scheduled start of the overhaul. I also understand it currently takes four months or more for the evaluation and negotiation of a contract for overhaul or conversion of a nuclear submarine after receipt of the shipyard's proposal.

5. I believe the above indicates that an unsatisfactory shipbuilding and overhaul contract situation at Ingalls will continue unless additional drastic steps are taken by NAVSHIPS. I recommend that the following action be considered:

a. Request Ingalls to accelerate the submission of their contract proposal for GUARDFISH as much as possible, regardless of past agreements.

b. Determine from the Type Commander and the Chief of Naval Operations the maximum acceptable delay in the scheduled start of GUARDFISH overhaul, and obtain agreement to delay the start of the overhaul until a priced contract has been signed.

c. Upon receipt of the Ingalls proposal for overhaul of GUARDFISH, assign an experienced contract negotiator to this contract full time until a priced contract has been signed.

(SHIPS 08 will provide the contracting officer with the technical analysis of the contractor's proposal for reactor plant work within two weeks of receipt of the proposal.)

d. Establish a firm schedule for resolution of SSN637 Class submarine contract delivery dates at Ingalls and for agreement on contract price adjustments.

e. Provide additional temporary staffing, if necessary, at SUPSHIP, Pascagoula, to:

(1) Ensure completion of a technical analysis of the GUARDFISH overhaul proposal within three weeks of receipt, and

(2) Analyze and settle outstanding submarine shipbuilding contract proposals from Ingalls.

f. Determine the steps necessary within the NAVSHIPS Contracts Division to support the above.

6. NAVSHIPS by inadvertence, is permitting itself to get into a position where it has abdicated its responsibility to control contracts--leaving the cost entirely in the hands of the contractor--by failing to reach timely agreement on firm contracts. Unless this situation at Ingalls is corrected at once, the Navy will again be accused of incompetence--and with no excuse.

7. I consider this situation to be serious enough to merit your immediate personal attention. I would appreciate being advised of the action you propose to obtain a definitive contract before the start of USS GUARDFISH overhaul and to settle outstanding contractual matters on SSN637 Class submarines under construction at Ingalls.

H. G. Rickover
H.G. RICKOVER

Copy to:
NAVSHIPS 09
02
04
425
PMS-381

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
Ser 08H-712
14 February 1970

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Shipbuilding and Overhaul Contracts for Nuclear Powered Ships at Newport News and Electric Boat; Request for Action Regarding

1. The purpose of this memorandum is to point out problems being encountered because of the unsatisfactory contract situation with Newport News Shipbuilding and Dry Dock Company and Electric Boat Division of General Dynamics Corporation, and to request that immediate corrective action be taken. My memorandum of 2 February 1970, Serial 08H-708, discussed similar contract problems with Ingalls Shipbuilding Division.

2. Newport News is presently proceeding under letter contracts with work which the Navy has estimated will cost over $500,000,000. I understand that at the present time Newport News does not have enough work in the yard to efficiently employ all of their work force. NAVSHIPS failure to obtain firm contracts for all of the work in this shipyard in a timely manner is providing a huge slush fund that may be subsidizing inefficient employment of labor to avoid lay-offs. Lack of an adequate cost control system at Newport News, which I have pointed out in previous memoranda, compounds this situation. The higher costs resulting from this situation become "historical costs" which Newport News will use to justify increased cost estimates, and thus larger profits, in future contract negotiations.

3. Electric Boat is proceeding under letter contracts with work which the Navy has estimated will cost over $200,000,000. In previous memoranda I have also pointed out weaknesses in Electric Boat procurement and cost control practices that result in higher costs for the government. NAVSHIPS failure to evaluate and negotiate firm contracts in a timely manner tends to encourage continuation of these poor practices with consequent higher costs for work at Electric Boat.

4. Because of the criticism being leveled at the Navy for the way it is handling ship contracts, I consider it most prudent that NAVSHIPS definitize the letter contracts for work in progress at Newport News and Electric Boat without delay. Further, to prevent a recurrence of the present situation, I consider that steps must be taken to ensure timely receipt of proposals and prompt evaluation and negotiation of contracts for all future work assigned to these yards. I recommend that you consider the following actions:

a. Assign enough experienced contract negotiators to expedite evaluation and negotiation of the proposals currently held by NAVSHIPS for CVAN 65, CVAN 68, CVAN 69, CVAN 70, SSBN 628, SSBN 629, SSBN 632, SSBN 633, SSNB 634, and SSN 685.

b. Establish firm schedules for receipt and evaluation of proposals for SSBN 636, SSN 637, DLGN 38 and SSN 688, and any future nuclear powered ships assigned to Newport News or Electric Boat. Ensure that all activities in NAVSHIPS responsible for the development of specifications or the evaluation and negotiation of proposals for overhaul and construction of nuclear powered ships understand the need for timely contract awards.

c. Identify and resolve outstanding contract and audit issues which could delay final award of contracts for work at Newport News and Electric Boat. For example, the government auditor at Newport News has taken exception to the entire overhead pool (over $25,000,000 in potential costs) proposed by the contractor for the CVAN 65 and SSBN 629 overhaul contracts. I understand that the auditor has requested NAVSHIPS assistance in obtaining access to company records which he deems essential for the evaluation of these proposals. To date NAVSHIPS has not made arrangements with Newport News to obtain the data the government auditor requires.

d. Take action with Newport News and Electric Boat to ensure timely receipt of proposals for future work. I discussed the problem of delayed proposals in my memorandum of 2 February 1970 with regard to Ingalls. One reason for delay in obtaining a firm contract with Newport News for the CVAN 65 overhaul was that the proposal was not received until two weeks after start of the overhaul--five months after the proposal was due.

5. The current contract situation with Electric Boat and Newport News, as outlined in the attachment is serious. I believe that unless you personally take action to improve this situation not only NAVSHIPS but the entire Navy will suffer from the consequences. NAVSHIPS will, because of inaction, be charged with nurturing cost overruns.

6. I would appreciate being advised of action taken in the premises for the ships listed in the attachment. If there are any specific actions within my cognizance I can take to assist in improving the situation, please advise me.

H. G. Rickover

H. G. Rickover

Copy to:
(next page)

Copy to:
09
02
04
07
425
PMS 381

STATUS OF OUTSTANDING LETTER CONTRACTS FOR NUCLEAR POWERED SHIPS WORK

Ship	Shipyard	Date Ltr Contract	Date Start Work	Date Proposal Rec'd (or Due)	Remarks
SSN685	EBDIV	12/16/68	12/16/68	6/5/69 11/5/69(Supplement)	Delay in negotiation. Technical Analysis completed 11/12/69. firm schedule for negotiations.
CVAN68 CVAN69 CVAN70	NNS&DDCO	5/16/68	5/16/68	10/3/68	Revised proposal rece 6/69. No firm schedu to definitize.
SSBN629	NNS&DDCO	4/4/68	5/13/69	9/10/69	No firm schedule to definiti these contracts.
SSBN632	EBDIV	4/25/68	7/8/69	4/4/69	
SSBN628	NNS&DDCO	2/3/69	11/8/69	7/21/69	
SSBN633	EBDIV	8/22/68	1/5/70	8/5/69	
SSBN634	EBDIV	8/22/68	7/15/70	8/5/69	
CVAN65	NNS&DDCO	3/15/68	8/15/69	8/29/69	Negotiations in proc

SHIPS SCHEDULED TO START WORK WITHIN 6 MONTHS FOR WHICH NO PROPOSAL HAS BEEN RECEIVED

SSBN636	NNS&DDCO	Unknown	7/15/70	Unknown	None
SSN688	NNS&DDCO	Unknown	Indefinite	Indefinite	None

Attachment to Memo Ser 08H-712

[illegible]
[illegible]
DEPARTMENT OF THE NAVY

Memorandum

DATE: 9 March 1970

FROM : SHIPS 00

TO : SHIPS 08

SUBJ : Shipbuilding and Overhaul Contracts for Nuclear Powered Ships at Newport News and Electric Boat

Ref: (a) SHIPS 08 Memo Ser 08H-712 of 14 February 1970

1. Your memo of 14 February 1970 has been reviewed by me and discussed with SHIPS 02 and we are both keenly aware that timely definitization or procurement action on the cases cited by you is of paramount importance.

2. There are, and have been, a number of problems which led to the present situation, some of which have been solved and others for which we are looking toward a solution as soon as possible.

3. Probably the main problem is a shortage of personnel in SHIPS 02 which has an assigned ceiling of 230 but only 210 on board at the present time. The majority of the shortage (13 of 20) is in the senior negotiator/contracting officer category. You are, no doubt, aware of the present restrictions on recruitment. Recognizing the seriousness of the situation, we have requested relief from the Chief of Naval Material and partial relief has been authorized. We are being permitted to recruit 8 of the 20 people under ceiling. In advance of the actions required to bring those people on board, SHIPS 02 has transferred three additional people from other procurement programs to assist in negotiating submarine construction, overhaul and conversion contracts.

4. With regard to your comment on access to records at Newport News, considerable work has been done by SHIPS 02, 07 and SUPSHIP Newport News to resolve this problem. Information received recently is that proper access to records has been obtained, the auditor has completed his review and is preparing supplemental audit reports removing previous qualifications on projected overhead.

5. For your further information I am attaching a list covering the ships cited in your memo and providing a brief analysis of what has happened to date and what is being done or remains to be done.

STATUS OF OUTSTANDING CONTRACTS

1. SSN-685. Negotiations were scheduled to start on 2/24/70. Due to illness of E.B. personnel, date was postponed to 2/26/70 but are now underway. Due to the significant difference between the E.B. proposal and the NAVSHIPS position based on cost analysis, negotiations are expected to be difficult and time consuming but are continuing toward a resolution. We expect to complete negotiations by the end of March and execute within two weeks thereafter.

2. SSBN 628 and 629. Because of similarities in the ships and the work required, contracting for these ships will be done as a single package. Due to the delay in a decision as to whether these ships would undergo an overhaul or a conversion, the proposal was delayed and the final audit report was not received until 2/9/70. This case has been assigned to one of the negotiators recently transferred to submarines and is currently being reviewed. We have established a target date for completion of negotiations by 27 April and execution by 14 May 70.

3. SSBN 633 and 634. After the Contractor's proposal was submitted, the time for the start of overhaul was changed. The Contractor is presently reviewing to see what is necessary to revise his proposal to reflect the later time span. As soon as we find out if a revised proposal can be expected and, if so, when it will be received, we will establish a firm contracting schedule. Based on the best available information we expect advice by 4/10/70, completion of negotiations by 5/20/70 and execution by 5/30/70.

4. SSBN 632. The Audit Report received on this overhaul contract was based on a new technique "correlation analysis" used by the Defense Contract Audit Agency. The results of this review put the negotiator in a most difficult situation. Members of your staff have prepared a rebuttal to the audit position to assist the negotiator in completing the definitization cycle. Based on this information we expect to complete negotiations by 5/7/70 and execute within two weeks thereafter.

5. SSBN 636 is one of a number of proposals due from Newport News schedules for which were discussed recently at a meeting in my office. At that time it was agreed that Newport News would submit a proposal on 12 March. We do not anticipate any particular difficulty in definitizing this contract prior to overhaul start, July 1970.

6. SSN 688. Mr. Packard's memo of 16 February 1970 did not authorize NAVSHIPS to contract for construction of SSN 688. It did authorize a letter contract for pre-production planning, procurement of long lead time materials and other preparation work. Newport News' position on required new letter contract clauses has been forwarded to Mr. Packard for action. In order to permit work to start pending resolution of the letter contract problem, a CPFF contract was awarded on 28 February 70. A proposal for construction of the ship is expected by 20 April 1970.

7. CVAN 65. Negotiations have been completed and the details of the agreement have been sent to the Chief of Naval Material for approval before executing the final document. Business Clearance expected by 13 March 1970 and execution by 20 March 70.

8. CVAN 68, 69 and 70. You are aware that at the present time we are addressing ourselves only to pricing of CVAN 68. CVAN 69 and 70 are not covered by letter contracts as yet. The most recent proposal on CVAN 68 is 26 November 1969, which will be supplemented on 9 March 1970, rather than June 1969 as shown in your memo. Before we can complete pricing actions on CVAN 68 and proceed to CVAN 69 and 70, we must obtain from the Contractor his final pricing arrangements pursuant to P.L. 87-653. Based upon receiving this data on 9 March, SHIPS 02 will be in a position to commence pricing negotiations during the week of 23 March, with a target completion date of 31 March 1970. Pricing of CVAN 69 is expected by 30 April 1970.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

08H-714
16 February 1970

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Control of Ship Construction Costs at Newport News Shipbuilding and Dry Dock Company

Ref: (a) Deputy Commander for Nuclear Propulsion Memo to Assistant Secretary of the Navy (Installation & Logistics) Ser 08H-1337 dated 30 April 1969
(b) Deputy Commander for Nuclear Propulsion Confidential Memo to Commander, Naval Ship Systems Command Ser 08H-01354 dated 23 September 1969
(c) Commander, Naval Ship Systems Command letter to Assistant Secretary of the Navy (Installation & Logistics) 0763:JF:dsr Ser 334 dated 23 November 1969
(d) DCAA Newport News Report dated 30 January 1970 on Newport News Shipbuilding and Dry Dock Company Estimating System
(e) Deputy Commander for Nuclear Propulsion Memo to Assistant Secretary of the Navy (Installation & Logistics) Ser 08H-370 dated 13 November 1968
(f) Chief of Naval Material Memo to Assistant Secretary of the Navy (Installation & Logistics) Ser MAT 02:RGF dated 15 May 1969

Encl: (1) Memorandum to VADM H. G. Rickover dated January 26, 1970; Subj: Cost Controls at Newport News Shipbuilding and Dry Dock Company

1. In references (a) and (b), I pointed out a number of serious deficiencies in procurement, pricing and cost control practices at the Newport News Shipbuilding and Dry Dock Company. Reference (c), on which you asked my comments, is your report to the Assistant Secretary of the Navy (Installation and Logistics) and the Chief of Naval Material on these deficiencies, identifing corrective actions planned by NAVSHIPS. My comments on each of the four principal sections of reference (c) are contained in the following paragraphs.

2. Cost Control
In references (a) and (b) I pointed out that Newport News has no effective budget system to control labor costs. Under the company's system it is possible to meet all working level budgets for a given ship and still overrun contracts.

Reference (c) however states:

a. Newport News has a reasonably good cost control system;

b. An effective system exists to insure that costs as charged are valid and accurate.

c. Some improvements can and should be made in the cost control system and that Newport News has agreed to adopt the NAVSHIPS recommendations for improvement.

d. Pending issuance of the Department of Defense (DOD) Guide for Performance Measurement described in DOD Instruction 7000.2 and an implementing Naval Material Command (NAVMAT) instruction and manual, NAVSHIPS will obtain copies of Newport News cost reports. The Supervisor of Shipbuilding at Newport News (SUPSHIPS) and the Defense Contract Audit Agency (DCAA) office at Newport News will monitor and expedite implementation of NAVSHIPS recommended improvements to the cost control system.

Comments

I do not understand how the Newport News cost control system can be classed "reasonably good" when their cost budgets do not and cannot act as a prompt and effective check on work actually being performed in the shops and on the waterfront. Under the Newport News system it is impossible to identify specific cost overruns in a timely manner or to make effective use of budgetary controls to safeguard against mischarging of costs. I identified this problem in references (a) and (b). In January 1970 the special NAVSHIPS team negotiating the contract for construction of the aircraft carrier CVAN 68 also found that present Newport News cost controls are not adequate to insure that work performed by their operating departments are within established budgets. Enclosure (1) states:

> "The review to date shows that there are two significant deficiencies in the present Newport News cost control system:
>
> 1. There is no way to insure that work performed by the operating departments is within cost budgets established under the Newport News cost control system.
>
> 2. It could take up to several months to determine whether a cost overrun condition exists and the reason therefor."

The January 30, 1970 Defense Contract Audit Office report on the Newport News estimating system (reference (d)) also refers to this problem. It states:

> "We now believe that the contractor should use the hardware oriented, work breakdown structure of the current production control system for cost accumulation...The present cost numbering system is too broad to pinpoint problems at the work package level. Rather than simply increase the number of cost categories, the cost numbering system should coincide with the production control numbering system *so that variances between budgeted and actual hours can be analyzed below the departmental level.* If the contractor cannot evaluate variances at the work package level, inefficiency will simply be perpetuated when cost returns are used as the basis for proposals." [Emphasis added].

The lack of effective cost control at Newport News leads to higher than necessary costs to the Government and thereby does great harm to the Navy's submarine and surface ship construction programs. Nearly all Navy work at Newport News is being performed under sole source, negotiated contracts under which the Government bears all or at least a substantial portion of cost overruns. Since profits on these contracts are negotiated as a percentage of estimated costs, higher costs result in higher profits in the long run. The company has little or no incentive to keep costs down. Therefore the Navy itself must take the initiative. Minor corrective measures will not suffice. Action is needed *now* to establish an *effective* cost control system.

3. Subcontracting

In references (a) and (b), I listed numerous deficiencies in Newport News procurement practices, particularly failure to comply with the Truth-in-Negotiations Act and failure to evaluate or negotiate subcontract prices effectively.

Reference (c) states:

> "The second basic issue involves subcontracting. The question here is what level of subcontract procurement performance should be expected from a contractor under a contract containing the "Consent to Subcontract clause."

Reference (c) further states:

a. Armed Services Procurement Regulation (ASPR) contract clauses do not require contractors to conduct subcontract procurements in the same manner as Government procurement is conducted.

b. NAVSHIPS will recommend a change to ASPR so that contractors would be contractually required to perform all the functions the Government would perform if it were awarding a contract in excess of $100,000.

c. Approval of the contractor's procurement system has been withdrawn. All applicable subcontracts will require Government consent prior to placement.

Comment

The issues I raised in references (a) and (b) do not hinge on the language of the ASPR "Consent to Subcontract clause." The point is that Newport News is not managing its procurements in a business-like manner and in accordance with the requirements of the Truth-in-Negotiations Act--to the financial detriment of the Government. More to the point, little or nothing is being done to require Newport News to improve its procurement operations.

In November, 1968, I pointed out deficiencies in Newport News procurement practices (reference (e)). In April, 1969, I provided a more detailed account of procurement deficiencies at Newport News (reference (a)). In May, 1969, the Chief of Naval Material confirmed the issues I raised. He said in reference (f):

> "The significant results of these studies are as follows;
>
> a. A significant portion of shipbuilding subcontracts are non-competitive (whether considering price or technical competition).
>
> b. Adequate pricing data is not being obtained on these subcontracts.
>
> c. Less than adequate effort is being made by prime contractors to:
>
> 1. Ensure adequate competition,
>
> 2. Perform adequate price analysis and conduct adequate negotiations.
>
> d. Bid prices on ships are in fact inflated by the sole source nature of many of the major subcontracts.
>
> e. Adequate emphasis is not being placed on P.L. 87-653 (Truth-in-Negotiations Act) and subcontract management by prime shipbuilding contracts.
>
> These results are borne out, I believe, by a similar review performed by Vice Admiral Rickover in the nuclear area."

In reference (c) you state that a CPSR (Contractor Procurement System Review) of the Newport News procurement system "to flush out deficiencies" is scheduled for February, 1970, more than one year after I first raised the issue. Reference (c) states further that SUPSHIPS will take "continuing action" to correct shipbuilder procurement deficiencies, i.e., we will go back to "business as usual".

I see no reason to continue studying and reviewing the procurement situation at Newport News. I consider that the deficiencies have been identified and confirmed. What is needed now is a firm commitment from Newport News to upgrade its entire procurement operation so that subcontracting is conducted efficiently. I see no need to await further reviews or changes in ASPR clauses before requiring this.

4. Contract Changes

In reference (a) I pointed out that because Newport News does not collect costs of change orders separately, neither Newport News nor the Government is presently able to determine the actual costs of changed work on ship construction contracts. There is no way to determine whether change orders have been overpriced.

In reference (c) you state that it is not feasible to maintain cost records for individual changes.

Comments

I do not agree that it is not feasible for the shipyard to maintain cost records for individual changes. I recognize that it may be difficult to establish rules for accounting for costs of changes. But the problem is not insurmountable. The shipbuilder prepares technical instructions and detailed work packages for change orders; I do not understand why he cannot account for the costs related to such technical instructions and work packages.

Obviously shipbuilders prefer not to account separately for the cost of each change. By lumping changes together and commingling their costs with other work, shipbuilders can overcharge the Government and make it impossible for the Government to know whether or not the price was too high.

I recommend that this issue be taken up with the Defense Contract Audit Agency and with the General Accounting Office to determine what rules should be established with regard to accounting for changes.

I consider that NAVSHIPS must require contractors to account for changes if it is to establish effective cost control and if it is to maintain the integrity of its fixed priced type contracts.

5. Internal Audits

In reference (a) I recommended that the Navy require Newport News to establish an effective program of internal reviews and appraisals of its operations. In reference (c) you state that Newport News is expanding its internal auditing staff to 12 from the present complement of 9. In reference (c) you imply that this problem is the responsibility of the Defense Contract Audit Agency (DCAA) not NAVSHIPS.

Comments

In reference (a) I stated that Newport News internal auditors seem to be concerned primarily with financial type auditing such as payroll verification. The addition of 3 more such auditors at Newport News will not correct the problem I raised. The need is for a strong internal audit organization whose efforts would be directed toward more efficient shipyard operations and more effective purchasing and cost control procedures. NAVSHIPS should obtain specific commitments from Newport News management to establish such an internal audit program.

The Navy, not DCAA, defends shipbuilding budget requests in Congress. Claims and overrun (cost growth) problems hinder the Navy in getting DOD and Congressional approval of its shipbuilding programs. The final responsibility for efficient and economical shipbuilding, therefore, cannot be shunted to local Government auditors.

6. For the reasons explained above, I believe that the actions you have described in reference (c) are inadequate to obtain any substantive improvements in Newport News procurement, pricing and cost control practices.

7. It appears to me that references (a) and (b) were referred for action to the very people in NAVSHIPS who for years have had the responsibility for administering shipbuilding contracts--the same people who are responsible for existing unsatisfactory conditions. Thus, the comments in reference (c), predictably tend to understate the problems and obfuscate the issues. Reference (c) gives the impression that NAVSHIPS now has all the problems under control. I know of no significant improvements in any of the problem areas I identified.

8. In my opinion, NAVSHIPS is not administering its shipbuilding contracts properly. Thus, after many years of dealing with Newport News and spending billions of dollars there, NAVSHIPS finds itself in the position where it must today initiate action to require Newport News to implement effective cost controls; to correct fundamental deficiencies in its procurement system; to implement the requirements of the Truth-in-Negotiations Act which was

passed by Congress eight years ago; and to implement an effective system of internal review. These facts are ample evidence that NAVSHIPS has not been effective in administering its shipbuilding contracts at Newport News.

9. I believe that these issues should be taken up with the President of Newport News and his commitment obtained for prompt and effective corrective action. I will be pleased to assist in this regard. Delay in obtaining such commitments and corrective actions will lead to further unnecessary cost to the Government.

10. I also recommend that the administration of Navy shipbuilding contracts be thoroughly reviewed. In my opinion, the Navy must reorganize and strengthen its administration of these contracts.

H. G. Rickover

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installation & Logistics)
Chief of Naval Material

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6
UNITED STATES GOVERNMENT

Memorandum

TO : VADM H. G. Rickover DATE: January 26, 1970

FROM : M. C. Greer

SUBJECT: Cost Controls at Newport News Shipbuilding and Dry Dock Company

Background

In connection with the negotiations with Newport News Shipbuilding and Dry Dock Company to definitize a contract for construction of CVAN 68, the NAVSHIPS negotiating team is performing a review of how Newport News controls ship construction costs. This review was considered necessary in order to determine whether or not Newport News cost control system is adequate to effectively control the costs of labor and material during CVAN 68 construction.

Summary and Conclusions

The review to date shows that there are two significant deficiencies in the present Newport News cost control system:

1. There is no way to insure that work performed by the operating departments is within cost budgets established under the Newport News cost control system.

2. It could take up to several months to determine whether a cost overrun condition exists and the reason therefor.

Thus it will be necessary to establish a special reporting system to review costs in constructing CVAN 68 and other nuclear ships. The Navy should require Newport News to improve its cost control procedures. In addition, the Navy should take steps to provide for adequate review of Newport News costs and cost control procedures by the Supervisor of Shipbuilding.

Discussion

On 16 January 1969, a meeting was held at NAVSHIPS to review Newport News cost controls for constructing CVAN 68. This meeting confirmed that Newport News has prepared and issued operating budgets for constructing NIMITZ. These budgets allocate contract dollars among cost groupings at the departmental level.

Buy U.S. Savings Bonds Regularly on the Payroll Savings Plan

5010-108

Separate from the cost control system, Newport News has a production control system for managing the work. Under the production control system the total construction effort is broken down into discrete time phased packages of work for accomplishment by shop and waterfront trades. Newport News also establishes manhour estimates for performing certain individual jobs in accordance with a labor incentive system. However, when questioned as to whether or not costs could be controlled under these various systems, the Newport News Contracts Manager stated that under the present system there is no way to insure that work performed by the operating departments under the production control system is within the cost budgets established by the cost control system. He also stated that Newport News had been working at resolving this problem for some time but had not yet found a satisfactory solution.

Based on these discussions the NAVSHIPS Contracting Officer recommended that a special NAVSHIPS team headed by the CVAN Program Manager be established to work with Newport News Cost Department personnel in developing a cost reporting system which will provide a valid means of determining the status of CVAN 68 labor construction costs and predicting cost overruns.

On 22 January the NAVSHIPS team and representatives from the Supervisor of Shipbuilding and the resident Defense Contract Audit Office met with Newport News Contracts and Cost Engineering personnel at Newport News. Newport News personnel explained that three basic cost reporting systems exist at Newport News:

a. A cost budget/cost reporting system by specific cost accounts.

b. A cost budget/cost reporting system functional department.

c. A profit and loss report by hull.

Costs as reported under the first two systems were reviewed in detail by the NAVSHIPS team. The third system involving profit and loss cost reporting was not made available for review. Based on its review the NAVSHIPS team concluded it was not possible to determine from the existing cost reports the status of costs incurred for ship construction work versus the expected costs to completion. Neither did the cost reporting system provide a means of identifying where or why cost overruns occurred so that specific corrective action can be taken to limit the overrun or prevent its recurrence. Newport News personnel stated that they compared the general trend of departmental labor costs to budgeted costs to determine whether a cost overrun condition exists. Newport News agreed that it could take several months to detect a cost overrun from the cost reporting system.

It is apparent that improvements in the existing Newport News cost control system are necessary. It was also apparent that because CVAN 68 construction work had been in progress for two years, it would not be possible to develop a reliable cost control system which related work as performed under the production control system to budgeted costs developed from a negotiated ship construction price. Instead, emphasis will have to be placed on developing a cost reporting system which will provide a means of determining the status of CVAN 68 labor costs. These costs will then have to be analyzed against the progress of the work in order to ferret out potential problems. The NAVSHIPS team will develop requirements for reporting cost progress and the expected completion costs of each cost grouping. Newport News agreed to review the NAVSHIPS requirements, and incorporate those requirements which are compatible with the existing cost control system.

On 23 January 1969, I telephoned the Supervisor of Shipbuilding, Newport News to inform him of the results of the NAVSHIPS review. I also asked who in his organization was responsible for monitoring the contractor's cost control system so that we could work with him in developing the Navy's cost reporting requirement. The Supervisor stated he had one person in the Purchasing Section who coordinated the correspondence and other actions pertaining to cost control. However, there was no one person with specific responsibility to monitor Newport News costs or Newport News cost control procedures. I recommended that he take steps to assign someone this responsibility. The Supervisor made no specific commitment to do so.

Recommendation

In view of the large amount of Navy business which will be awarded to Newport News on the basis of negotiation rather than competitive prices and the Government risk of cost overruns on these contracts, I recommend that you again take this matter up with the Commander of the Naval Ship Systems Command. I believe that the Commander should obtain specific commitments from the President of Newport News to initiate immediate improvements in its cost control system. I further recommend that action be taken to provide for adequate review of shipyard costs and cost control procedures by the Supervisor of Shipbuilding at Newport News, and at other shipyards where the Government bears substantial cost risk in its contracts.

M. C. Greer

[illegible]
[illegible]
[illegible]

[illegible]
08H-718
19 Feb 1970

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS & LOGISTICS)

Via: (1) Commander, Naval Ship Systems Command
(2) Chief of Naval Material

Subj: Procurement Practices and Cost Control under Navy Contracts with Electric Boat Division, General Dynamics Corporation, for Design, Construction, and Overhaul of Nuclear Submarines

Ref: (a) Deputy Commander for Nuclear Propulsion Memorandum to the Assistant Secretary of the Navy (Installations & Logistics) Ser 08H-01354 of 23 September 1969
(b) Commander Naval Ship Systems Command Letter to the Assistant Secretary of the Navy (Installations & Logistics) Ser 357 of 24 November 1969
(c) Commander Naval Ship Systems Command Letter to the Assistant Secretary of the Navy (Installations & Logistics) 0763:JF:dsr Ser 2 of 20 January 1970
(d) Deputy Commander for Nuclear Propulsion Memorandum to Commander, Naval Ship Systems Command Ser 08H-714 of 16 February 1970

Encl: (1) Comments on NAVSHIPS review of Electric Boat Subcontracting
(2) Comments on NAVSHIPS review of Electric Boat Cost Control
(3) Comments on NAVSHIPS review of Electric Boat Progress Payments
(4) Comments on NAVSHIPS review of Principles and Procedures for Settling Shipbuilder Claims and Change Orders
(5) Comments on NAVSHIPS review of Government Surveillance of Operations at Electric Boat

1. On September 13, 1969, I forwarded to you a comprehensive report, reference (a), pointing out many serious deficiencies in cost control and procurement practices under Navy ship design, construction and overhaul contracts with the Electric Boat Division of General Dynamics Corporation. This report shows that the Government is paying more than it should for the work being done; there are wide-spread deficiencies in procurement practices; there is inadequate control over labor and material costs charged to Government contracts and inadequate Government surveillance of contractor operations. I pointed out that the situation at Electric Boat warranted further investigation by experienced procurement and cost control specialists to establish the full facts and to develop comprehensive corrective measures to preclude such waste of Government funds in future. I gave several specific recommendations for corrective action at Electric Boat and at other shipyards.

2. On November 24, 1969, Commander, Naval Ship Systems Command (COMNAVSHIPS), by reference (b), forwarded to you reports on these deficiencies from the Resident Defense Contract Audit Agency (DCAA) Auditor and from the Supervisor of Shipbuilding (SUPSHIPS) at Electric Boat. On January 20, 1970, COMNAVSHIPS, by reference (c), forwarded to you six enclosures summarizing NAVSHIPS review of the issues I had raised and presenting his conclusions and planned actions with regard to my recommendations.

3. In their reports, the Resident DCAA Auditor and SUPSHIPS took exception to many of the issues I had raised. COMNAVSHIPS also expressed disagreement with several of my conclusions and recommendations. In those cases where COMNAVSHIPS indicated agreement with me, he cited at some length NAVSHIPS actions which have been or were being taken, indicating that most or all of these actions were taken or would have been taken regardless of my report. In sum, the conclusions of the Resident DCAA Auditor, SUPSHIPS Groton, and COMNAVSHIPS are that my report is in error with respect to many basic facts; that in those areas where my report is correct, the cognizant officials were already well aware of the problems and were taking appropriate actions to correct them; and that the thrust of many of my recommendations would be to treat Electric Boat as a "captive" plant, contrary to the Department of Defense (DOD) policy of "disengagement" which contemplates minimal interference in a contractor's operations. In reference (c) COMNAVSHIPS states:

> "....Our SUPSHIPS offices are staffed in an austere manner in accordance with the DOD policy of disengagement; tightening control and surveillance over the Contractor would require increased SUPSHIPS personnel. Nowhere in any of the recommendations made by the Deputy Commander is it contended that a better ship would result, only that the contract cost would be lower. I am unable to determine that the short-range costs of closer surveillance of flexibly-priced contracts, due to increased contractor overhead and increased SUPSHIPS staffing will be offset by the savings that are implied by the suggestions of reference (a)...."

4. COMNAVSHIPS statement that "nowhere in any of the recommendations made by the Deputy Commander is it contended that a better ship would result, only that the contract cost would be lower" is not germane to the issues I raised. Of course I am interested in obtaining high quality ships. I am also interested in carrying out Presidential, Congressional, Secretary of Defense, Secretary of the Navy, Chief of Naval Material, COMNAVSHIPS and your own instructions to see to it that work is done in the most economical manner.

5. Electric Boat is a "captive" plant by its own choice: more than 98 percent of all business at the yard is Government work. Most of this

work is under sole source, negotiated contracts under which the Government bears all or a substantial portion of any cost overruns. Since profits on these contracts are negotiated as a percentage of estimated costs, higher costs, in the long run, result in higher profits. Thus the contractor has little or no incentive to keep costs down. In these circumstances the Government cannot afford to rely on Electric Boat to protect the Government's financial interests--as my report amply shows.

6. Instead of thoroughly investigating the issues I raised, COMNAVSHIPS has simply referred my report to the very people who for years have had the responsibility for administering shipbuilding contracts--the very same people who are responsible for the unsatisfactory conditions at Electric Boat. Their response, of course, is that everything is under control and being well-handled by the existing organization. Thus, there have been no significant improvements in any of the problem areas I pointed out.

7. Enclosure (1) through (5) contain my detailed comments on each of the principal issues covered by COMNAVSHIPS in references (b) and (c). I strongly disagree with the conclusions drawn by COMNAVSHIPS and with those of the Resident DCAA Auditor and of SUPSHIPS at Electric Boat. For example:

a. In enclosure (1) to reference (c) COMNAVSHIPS states that the procurement deficiencies I reported were known prior to my 13 September 1969 report; that Government approval of Electric Boat's procurement system was permitted to lapse on 1 October 1969; and that the Supervisor of Shipbuilding will take "continuing action" to correct contractor procurement deficiencies.

The procurement deficiencies at Electric Boat should have been known long before September, 1969. My November, 1968, letter to your predecessor and my follow-up letters to you in February and March, 1969 concerning the need for improvement in ship procurement practices were attempts to bring the problems in this area to the attention of the responsible Navy officials. However, it is obvious that little has been done to improve Electric Boat procurement practices. Attachment A to enclosure (1) of this letter is a current example of poor procurement practices by Electric Boat resulting in NAVSHIPS repeated rejection of an Electric Boat procurement recommendation. Most significant is the failure of Electric Boat management to recognize the seriousness of the deficiencies in their procurement practices. Obviously NAVSHIPS has not been effective in getting contractor management to work constructively to correct procurement practices.

b. The Resident DCAA Auditor states that the contractor's system for the accounting and control of labor costs is adequate and that the Government's surveillance of the contractor's labor charging practices has also been adequate. I can ascertain no factual basis for this conclusion. These areas have not been reviewed adequately. Numerous deficiencies still exist in the contractor's material control system; as of 31 December 1969, the Government was still being denied access to pertinent financial information. I do not know whether the Government auditor has yet been able to obtain access to such information.

c. COMNAVSHIPS reports that the present progress payment procedure which allows Electric Boat to obtain payment from the Government for materials before Electric Boat actually incurs the cost and before materials are issued from inventories is "acceptable to NAVSHIPS and DCAA." COMNAVSHIPS further points out that progress payments on fixed priced type contracts are based on physical completion rather than incurred costs. The implication is that Electric Boat's mischarging of material costs has no impact on shipbuilding contract payments.

Again I do not believe NAVSHIPS has looked adequately into the issues I raised. The contractor certainly considers that advance charging of material costs to the Government has a significant effect on shipbuilding contract payments. For example, Electric Boat recently paid one of its employees an incentive award of $1,231 for suggesting that certain miscellaneous inventories of stock be charged off to the Government before they are used, so that a progress payment could be collected. The employee, in his suggestion, stated:

> "Presently the Government cannot be billed until the material is actually used. By adopting an allocated type inventory for this material, the Government can be billed when the material is paid for because it is bought for use on a specific contract. Then, in effect, the Government finances this inventory for Electric Boat Division...[This suggestion] generates funds for Electric Boat."

Thus, in this case the Government will not only be paying higher progress payments, it will also have to pay 98% of the incentive award which led to the higher progress payments by the Government.

d. COMNAVSHIPS considers present procedures for handling claims and contract changes to be adequate. I cannot understand how such a conclusion could be reached when contractors are allowed to commingle costs of changes with other work such that there is no firm basis for the Government to verify the costs claimed by contractors.

e. Present hiring practices by the Supervisor of Shipbuilding are acceptable to NAVSHIPS even though about one-third the personnel representing the Government at Electric Boat are former Electric Boat employees. While the practice of staffing Government contract administrative offices with former contractor employees may be permitted by law or regulation, such action surely cannot be in the Government's interest.

f. The lack of detailed Government surveillance of the contractor's operations at Electric Boat is attributed by COMNAVSHIPS to DOD's policy of "disengagement", under which the Government relies on the contractor to control costs under Government contracts. Such an approach, particularly in a shipyard doing 98% of its business with the Government makes no sense. With respect to this question of contractor-Government relationships there is no question but that the Navy has been complying fully with "the DOD policy" of minimal interference. As a result, the contractor is engaging in a wide variety of practices which are no doubt beneficial to him, but costly to the taxpayer.

8. The issues I raised are fundamental to sound administration of the Navy's shipbuilding program. They are not minor procedural matters as one might infer from reading the referenced COMNAVSHIPS letters to you. I believe that the seriousness of these issues and their adverse impact on the Navy is not yet understood. Unless we take prompt action to bring costs under control, the Navy will not be able to get funds from Congress to build all the ships it needs.

9. The NAVSHIPS actions on the issues I raised in reference (a) reminds me of a similar experience more than 10 years ago. In 1959, I pointed out several overcharges on Government contracts by the Bethlehem Steel Company's Quincy shipyard to the Comptroller of the Navy. His response was to tell me that I should mind my own business and that I could rest assured his auditors were seeing to it that the Government was being treated fairly. It was not until the GAO two years later investigated the issues I raised that the Navy finally took action to recover these overcharges. The result was a GAO report to Congress and severe criticism of the Navy--criticism which could have been avoided had Navy officials taken corrective measures when I raised the issues, instead of defending their past actions. Moreover, it took the Navy 7 years to settle these issues on an after-the-fact basis. The Navy then had to settle for 50 cents on the dollar for money it wasted because of inadequate contract administration. I hope the Navy will not again wait for the GAO to raise the issue with Congress before it takes action to correct procurement and cost control deficiencies at Electric Boat, as well as at other shipyards.

10. Over the years, I have worked hard to improve administration of our shipbuilding contracts. I have spent a great deal of my time and that of my leading people in pointing out deficiencies that come to my attention to cognizant naval authorities. Invariably the response to my comments by the officials concerned is to deny that real problems exist, and to cloud the issue with bureaucratic policy and procedural comments in defense of what they have been and are doing. Little or no action is taken. Inevitably, however, the facts come to light. I do not make comments and recommendations lightly or without careful consideration of the facts.

11. In my opinion these issues warrant your personal attention and direction. Without such personal involvement, nothing will be done; references (b) and (c) clearly attest to this. I recommend that you take these issues up with General Dynamics management and obtain commitments for prompt and effective corrective actions. Further, I recommend that you assign a competent and qualified person to keep track of the progress made in correcting these deficiencies and keep you advised of progress. Finally, I recommend that steps be taken to thoroughly review the administration of Navy shipbuilding contracts. Our SUPSHIPS organizations devote much time to the review and inspection of technical data, plans, ship construction and so forth. Their effort is also needed to review and monitor cost control, procurement, and management of contractor operations.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations & Logistics)
Chief of Naval Material

ENCLOSURE (1)

VADM Rickover Comments on NAVSHIPS Review of Electric Boat Subcontracting

1. Problem & Recommendations, as Stated in VADM Rickover's Report Dated 23 September 1969:

There are widespread weaknesses in the company's procurement operations.

Specifically:

a. Procurement files do not adequately justify prices being paid by Electric Boat.

b. There seems to be an excessive and unwarranted amount of sole-source procurement. It appears that many of these sole-source procurements have been overpriced.

c. Electric Boat is not making effective use of the Truth-in-Negotiations Act to obtain the lowest possible prices for the Government.

d. Insufficient effort is being expended to reduce the cost of supplies and materials charged to Government contracts.

e. Competitive procurements are not handled properly. As a result, there is no assurance that all qualified firms have an equal opportunity in the bidding process or that reasonable prices are being obtained.

f. The lax procedures and practices employed in the procurement of equipment and material for Government contracts are in sharp contrast with the close attention paid by Electric Boat and General Dynamics Management in procurements involving corporate funds.

The Navy should withdraw approval of the procurement system. The company should be required to submit all proposed subcontracts in excess of $25,000 for Government review and approval prior to placement.

2. COMNAVSHIPS Response & Proposed Action:

COMNAVSHIPS states:

"The approval of the system was permitted to lapse on 1 October 1969. Prior consent of the Contracting Officer to the placement of a subcontract is now required for subcontracts under those contracts containing the

"Subcontracts" clause.... NAVSHIPS does not consider it necessary to negotiate an agreement with the contractor to modify existing contractual requirements in order to obtain the contractual right to approve all subcontracts in excess of $25,000. NAVSHIPS will direct SUPSHIPS to review on a sampling basis, to the extent of available resources, subcontracts over $25,000 under those contracts containing the "Subcontract" clause."

Proposed Action:

	Item	Target Date
a.	SUPSHIP actions to correct contractor's Procurement deficiencies	Continuing Action
b.	SUPSHIP to conduct sampling reviews of subcontracts over $25,000	Continuing Action

3. Comments on COMNAVSHIPS Response and Proposed Action:

Enclosure (1) to reference (b) states that "prior to the review reported by reference (a), NAVSHIPS became concerned with the subcontracting procedures in the shipbuilding industry." The enclosure went on to state that SUPSHIP became aware "that deficiencies existed in the contractor's system in placing subcontracts prior to the review contained in reference (a). This concern was reflected in a letter of 8 July 1969 to NAVSHIPS requesting that a qualified Procurement Methods Analyst be provided to conduct a review of the contractor's procurement system."

The problem should have been known for some time. In November, 1968, I reported to the Commander of the Naval Ship Systems Command, the Chief of Naval Material, and the Assistant Secretary of the Navy (Installations

& Logistics) a number of specific examples of Electric Boat and Newport News procurements which indicated serious deficiencies in the procurement operation of these two yards. In April, 1969, I submitted a detailed report of deficiencies in procurement and cost control practices at Newport News. However, Electric Boat continued to operate under a Government-approved procurement system until Government approval was allowed to lapse on October 1, 1969--the normal expiration date for the approval granted the year before.

Although I raised this issue in November, 1968, a Government review of Electric Boat's procurement system was not conducted until October-November, 1969. This review confirmed the deficiencies I reported. Thus more than a year has passed since I first pointed out problems regarding how Electric Boat was conducting its procurements under Government contracts. During this time, Electric Boat procurements were running at an annual rate of $50 to $80 million; about 30% of the cost of each ship built at Electric Boat is spent through Electric Boat's purchasing department.

Attached to this enclosure is a series of letters between NAVSHIPS and Electric Boat on a pending forging procurement for SSN 685. It is apparent from Electric Boat's actions and their statements that nothing concrete has been accomplished by NAVSHIPS or SUPSHIP "continuing action" to correct procurement deficiencies. Of most significance is that Electric

Attachment A to Enclosure (1) to NAVSHIPS letter 08H-718 dated February 19, 1970

Procurement of Main Sea Water System Fittings for SSN 685

Electric Boat letter dated November 25, 1969, requested NAVSHIPS consent to procure SSN 685 main sea water system fittings from Taylor Forge Division of Gulf and Western Industrial Products Company at a price of $482,014.79.

NAVSHIPS letter 08H-6402 dated December 19, 1969, disapproved the Electric Boat request noting bid procedures were not adequate to support a competitive award, negotiations were not conducted with all suppliers in a competitive range and Electric Boat did not perform a price analysis to establish the reasonableness of the recommended price. NAVSHIPS requested Electric Boat reopen negotiations with both bidders (Taylor Forge and Tube Turns).

Electric Boat letter dated January 6, 1970, forwarded by SUPSHIPS letter Ser. 400-4C dated January 8, 1970, requested NAVSHIPS approval to proceed with award of the main sea water fitting order as originally recommended and without reopening negotiations.

NAVSHIPS letter 02B:JF:epm Ser 1 dated January 29, 1970, again disapproved the Electric Boat request due to the previously noted deficiencies. Electric Boat was requested to reopen negotiations with both Taylor Forge and Tube Turns to obtain the lowest price for the required work.

Electric Boat letter dated February 10, 1970, forwarded by SUPSHIPS letter Ser 400-23C dated February 12, 1970, requested NAVSHIPS concurrence to a proposed procedure in handling this procurement. Electric Boat proposes to issue a new invitation to bid to Taylor Forge and Tube Turns. Electric Boat requests NAVSHIPS approval to accept the low bid without further negotiation.

NAVSHIPS letter 022C:JF:epm Ser 2 dated February 18, 1970, insists that Electric Boat reserve the right to negotiate if necessary to obtain a reasonable price. Electric Boat is again informed that Government consent to this procurement will not be granted unless Electric Boat can establish the reasonableness of the price.

Boat Management does not appear to recognize the seriousness of the deficiencies in their procurement practices. Thus NAVSHIPS has not been effective in getting Electric Boat Management to take action to upgrade its procurement operations.

I consider that NAVSHIPS has placed too much concern on procedural matters and in defending past actions. NAVSHIPS has operated too long on the premise that its shipbuilding contracts have been awarded in a highly competitive market such as one might expect to find in procuring bread or clothing. This accounts for the belief on the part of many Government officials that the Government can rely on its contractors to spend public funds prudently.

The principle involved is fairly simple. Large amounts of Government funds are at stake in the procurement operation of shipbuilders such as Electric Boat. There is ample evidence that these funds are not being spent prudently. I have repeatedly pointed out that shipbuilders have no incentive to tighten up their procurement organizations. Shipbuilding is a noncompetitive business. The Navy must take action with its shipbuilders to get their procurement on a sound basis so that the Navy gets fair value for its money.

Enclosure (2)

VADM Rickover's Comments on NAVSHIPS Review of Electric Boat Cost Control

1. Problem & Recommendations, as Stated in VADM Rickover's Report Dated 23 September 1969:

Labor and material costs are being mischarged on Government contracts.

Specifically:

a. Under the present labor charging system supervisors have a strong incentive to charge labor costs to the labor budget account that can best absorb the cost and not necessarily to the budget account for the work actually performed.

b. A comprehensive review of Electric Boat's labor charging practices has not been conducted. However, there are indications that labor costs are being mischarged. There are no effective controls to preclude such mischarging.

c. Electric Boat's material control system contains serious deficiencies such that the validity of material costs charged to Government contracts cannot be determined.

The Navy should withdraw approval of Electric Boat's accounting system until effective controls are established to preclude mischarging of labor and material costs on Government contracts.

2. COMNAVSHIPS Response & Proposed Action:

COMNAVSHIPS states:

"The Resident DCAA Auditor in his report . . . states that the accounting system was never approved; therefore, withdrawal is not appropriate. Also the Auditor reports the reviews that DCAA has conducted of the company's labor charging practices, system, and controls, and has concluded that:

> 'We disagree with the Code 08 conclusions that the contractor's system for the accounting and controls of labor costs is inadequate and that the Government's review of the contractor's labor charging practices has been inadequate.'"

* * *

> "...While we [NAVSHIPS] agree with the Resident DCAA position quoted above, we do consider that, if the company's financial audit staff were to be augmented permanently to perform additional labor charging floor checks and material reviews, it could relieve DCAA of some of its surveillance function in this area to permit other utilization of Government auditors."

Proposed Action:

	Item	Target Date
a.	Contractor to review direct labor budget workflow.	Continuing Action
b.	Contractor to review physical progress estimating workflow.	Continuing Action
c.	Contractor to revise the cost account structure.	Continuing Action
d.	Contractor to identify overhaul work by specification item.	Continuing Action
e.	Contractor to revise manhour level of direct labor budgeting.	Continuing Action
f.	Contractor to relate physical progress to cost-to-complete and the budgeting/cost control work authorization system.	Continuing Action
g.	Contractor to develop a top management report on vessel status.	Continuing Action
h.	Contractor to develop a user-oriented manual for direct labor budgeting and cost control	Continuing Action
i.	Contractor to review requirements for data processing programs.	Continuing Action
j.	Contractor to increase internal review staffing for labor material checks and consider establishing a separate Internal Review organization.	Continuing Action

3. Comments on COMNAVSHIPS Response and Proposed Action:

It is not surprising that the auditor and NAVSHIPS have not found mischarging of costs. The issue is that neither the Navy nor the contractor have established adequate procedures to check on labor and material charges. Thus when my representative checked into this matter, he readily found the situation described in reference (a).

As long as the Navy depends on "continuing action" with the contractor to deal with these problems, they will not be identified or solved. If the Government auditor would make a careful review of this situation, he would find it to be as bad as or worse than stated in my report.

While I agree that Electric Boat should have an effective internal audit staff, the NAVSHIPS suggestion that additional Electric Boat auditors can relieve this burden from the DCAA represents a fundamental misunderstanding of the relationship between the Government and Electric Boat. As I have reported time and again, Electric Boat has practically no incentive to hold down costs on its Government contracts. Indeed, increased costs can be profitable for the company. Since this is true, it is naive to assume that we can rely on company auditors to hold down costs.

If the Resident Auditor does not have the time or manpower to make a comprehensive study of cost charging practices at Electric Boat, then the Navy should send a special team to study the situation -- as was done at Newport News.

Enclosure (3)

VADM Rickover Comments on NAVSHIPS Review of Electric Boat Progress Payments

1. Problem & Recommendation as Stated in VADM Rickover's Report Dated 23 September 1969:

Electric Boat is receiving interest-free progress payments for material before the material has been used, and sometimes before the yard itself has paid for the material.

The Navy should revise progress payment procedures so that General Dynamics Corporation no longer gets interest-free use of Government funds.

2. COMNAVSHIPS Response & Proposed Action:

COMNAVSHIPS states:

"Enclosure (1) of reference (b), the report of the Resident Auditor, provides an explanation of material charging and material progress payment practices of Electric Boat. Such practices are acceptable to DCAA and to NAVSHIPS. On other than cost type contracts, progress payments are not based on costs incurred but on physical progress; they are limited to no more than 105% of costs. For such contracts, SUPSHIPS, with the assistance of DCAA, verifies monthly the material physical progress and quarterly, the certification that the progress payment requested does not exceed 105% of costs. The SUPSHIPS Quality Assurance Department, by a sampling technique, verifies the percent of labor physical progress claimed and makes its own progress calculations."

Proposed Action:

No corrective actions are necessary.

3. Comments on COMNAVSHIPS Response and Proposed Action:

I do not believe NAVSHIPS has adequately looked into the issue I raised. The implication in references (b) and (c) is that Electric Boat's charges for material costs has no impact on shipbuilding contract payments.

The contractor certainly considers that advance charging of material costs has a significant effect on shipbuilding contracts. For example, Electric Boat recently paid one of its employees an incentive award of $1,231 for suggesting that certain miscellaneous inventories of stock be charged off to the Government before it is used so that a progress payment could be collected. He stated in his suggestion:

> "Presently the Government cannot be billed until the material is actually used. By adopting an allocated type inventory for this material the Government can be billed when the material is paid for because it is bought for use on a specific contract. Then, in effect, the Government finances this inventory for Electric Boat Division.../This suggestion/ generates funds for Electric Boat."

Thus in this case the Government will not only be paying higher progress payments, it will also have to pay 98% of the incentive award which led to the higher payments.

The impression one gets in reading the NAVSHIPS and DCAA comments is that the present method of charging costs for progress payments is acceptable because such actions are not prohibited by ASPR. In this regard, the Navy arranged through the ASPR committee some years ago to use a special progress payments clause for shipbuilding contracts. It appears that the shipbuilding clause as it is presently being administered is more liberal than is the standard ASPR progress payments clause used in other contracts, and results in an unwarranted subsidy to shipbuilders.

I believe the Navy is subject to severe criticism if it allows this situation to persist. Prompt action is needed to correct this situation.

Enclosure (4)

VADM Rickover's Comments on NAVSHIPS Review of Principles and Procedures for Settling Shipbuilder Claims

1. Problem & Recommendations as Stated in VADM Rickover's Report dated 23 September 1969:

   a. Under the present system, there is no way to insure that the Government is not being overcharged in the adjudication of changes or in the settlement of claims.

   b. Present procedures for handling claims against the Government for changed work seem to be heavily weighted in favor of the contractor. The Navy should establish principles, procedures, and means to place the Government on equal footing with the contractor in settling change orders and claims.

   c. Electric Boat normally does not account separately for the cost of changed work. Thus, settlement can only be made on the basis of judgment and rough estimates.

   d. Electric Boat has a "claim team" of 75 full-time employees to identify and prepare any potential claim on work in the yard. This team prepares voluminous claims which the Government--lacking both time and manpower--cannot possible refute *in toto*. Since the cost of this team is charged to each claim, the Government actually pays for most of this effort, even though it benefits the contractor, not the Navy.

2. COMNAVSHIPS Response and Proposed Action:

   COMNAVSHIPS states:

   ". . .reference (a) recommends the establishment of principles, procedures and means to place the Government on an equal footing with the Contractor in settling change orders and claims. NAVSHIPS concurs with this recommendation and considers that such principles, procedures and means do now exist as detailed in enclosure (4). . . ."

Proposed Action:

NAVSHIPS to carry out its decision to assign counsel to certain SUPSHIPS offices.

3. Comments on COMNAVSHIPS Response and Proposed Action:

The NAVSHIPS detailed response enumerates twelve actions NAVSHIPS has taken over the years to help the Government deal with contractors more effectively with regard to claims and changes. Many of these actions are procedural items, others involve improved contract clauses, revised organizations, and increases in civilian personnel staffing at SUPSHIPS since 1965. No doubt the Government is better off today because of these actions. However, I am discussing conditions I see today.

Because Electric Boat normally does not account separately for the cost of changed work, there is no factual record from which either Electric Boat or the Government can determine the actual cost of work that is the basis for the claim. Those charged with the responsibility for settling claims must rely mostly on "judgment" and independent estimates in arriving at a proper settlement. This is true even though the work is often accomplished long before the claim is settled.

Under these circumstances, the Government must depend primarily on the contractor's estimates and his representation of the circumstances in settling claims. To refute the contractor's claim, or to challenge with any authority his cost estimate requires considerable time and effort. Historically there is a large backlog of claims and unadjudicated changes. These outstanding claims are sometimes grouped together and an overall settlement reached. Consequently, the Government cannot tell on a job-by-job basis how much Electric Boat really spends for the extra work claimed or what the Government paid for it.

On the average, change orders increase the price of a submarine by 15 percent or more. As long as shipbuilders can commingle the cost of these changes with other work, they can overcharge the Government and make it impossible to know whether or not the price is too high. Further, effective cost controls for either the changed work or the basic work are impossible under this arrangement. As pointed out in my memorandum dated 16 February 1970 (reference (d)), I believe this issue should be taken up with the Defense Contract Audit Agency and with the General Accounting Office to determine what rules should be established with regard to accounting for changes.

The basic issue I raised was that the Government was not on equal footing with the contractor in settling claims. The assignment of one lawyer in the SUPSHIPS office will not resolve this issue. The Government cannot possibly compete in this manner with the 75 full-time employees the contractor has to prepare and prosecute its claims.

I recommend that a special task group be formed to review how shipbuilders' claims are being prepared, prosecuted, and settled and what changes should be made to protect effectively the Government's interest.

Enclosure (5)

VADM Rickover's Comments on NAVSHIPS Review of Government Surveillance of Operations at Electric Boat

1. Problem & Recommendations as Stated in VADM Rickover's Report on Newport News Dated 13 September 1969:

My report pointed out that the Navy must establish appropriate controls at Electric Boat and at other shipyards. It stated:

a. "Although Government business accounts for 98 percent of the work at Electric Boat, Government auditors do not have access to certain Electric Boat financial reports that are essential in determining the reasonableness of charges to Government contracts.

b. "Government representatives do not review the company's "Make or Buy" decisions and there are indications that such decisions are not always made with the interests of the Government foremost.

c. "The Supervisor of Shipbuilding does not review Electric Boat procurements from other divisions of General Dynamics Corporation. The contractor does not justify the cost of these procurements or indicate whether or not these items are being obtained at less cost than would be possible from other companies.

d. "A number of former Electric Boat employees are working in the offices of the Supervisor of Shipbuilding and the Government Auditor. This situation is not conducive to proper business relationships between the Government and Electric Boat."

The Navy should issue policy instructions to preclude employment of former contractor personnel in positions where they are responsible for reviewing contractor operations in the activity where they were formerly employed.

2. COMNAVSHIPS Response & Proposed Action:

The DCAA Auditor states:

> "Presently we do have access to all accounting and financial records which we consider necessary to the performance of our audit responsibilities."

COMNAVSHIPS states:

> "Consideration will be given to including a make-or-buy clause in the contract when the solicitation contains make-or-buy requirements. For contracts which have already been awarded to Electric Boat, NAVSHIPS will explore the feasibility of including a make-or-buy clause, providing that most of the high cost items have not already been procured."

* * *

> "As to that portion of the recommendations of reference (a) which concerns the decision to assign work to other General Dynamic Divisions, ASPR treats such intra-company matters as "make" items. Accordingly, when a make-or-buy program requirement is included in a solicitation, the contractor will have to provide information on "make" items and the contract will be negotiated on the basis of the acceptability of such a "make" item. After contract award, changes in the "make" decision will require approval by the Contracting Officer only if the contract contains the make-or-buy clause."

* * *

> "Both the Resident DCAA and the SUPSHIP disagree with the implication that proper business relationships between the Government office and Electric Boat have been impaired because of the employment of former Electric Boat employees. A parallel situation exists in NAVSHIPS Headquarters, which employs former contractor personnel in positions having engineering surveillance responsibilities over the activities where they were formerly employed, and we consider that proper objective relationships exist in these cases. It would appear that the employment of former contractor employees at the levels found in a SUPSHIP office actually works to the disadvantage of the contractor rather than the Government in that such personnel are usually well trained and are aware of the weaknesses of the contractor which require closer surveillance by the Government. NAVSHIPS knows of no law or Civil Service regulation which would authorize the issuance of a blanket prohibition against employing former contractor personnel in such circumstances."

3. Comments on COMNAVSHIPS Response and Proposed Action:

On 31 December 1969, the DCAA Auditor wrote Electric Boat as follows:

> "Subject to various verifications pending the resolution of the access to records problem regarding the "Quarterly Contract Analysis" and "Contract Profit Forecast Data" reports, we have concluded a review of Electric Boat Division's financial management practices for compliance with ASPR Section VII, Part 2, limitation of cost and/or funds clauses under cost-reimbursement type contracts, and management's practices affecting costs under cost-type and fixed-priced contracts. The review concluded that a system exists to generate timely data for financial management and the reporting of the financial status of individual contracts. However, disclosures of significant cost overruns or underruns are not being made to the Contracting Officer on a timely basis. Also, until we are provided access to the above mentioned reports, we cannot render an opinion on the adequacy of the system."

(Emphasis Added)

* * *

> "Since we have been denied access to certain contractor reports, we cannot report on the accuracy of the estimates to complete. Due to the critical nature of Government funds and because of the deficiencies noted in our review, this office is particularly concerned with the projected cost to complete contracts by element of cost. This information is available only on the "Contract Profit Forecast Data" report. Access to this report and the "Quarterly Contract Analysis" report is considered essential for us to conclude that the contractor's financial management system is adequate and responsive to Government procuring agency needs."

I do not know whether the Aduitor yet has the reports he requires. Obviously he did not have them at the time he wrote enclosure (1) to reference (b).

With regard to make-or-buy decisions, I consider that each significant order to be placed with other divisions of General Dynamics should be reviewed by the Government to ensure that the business arrangements are proper and that the lowest price to the Government is obtained for the work required. I do not think this will be the case under the procedures set forth in reference (c). Therefore I consider additional procedures should be established requiring the Supervisor of Shipbuilding review and approval of intra-company orders over $25,000 on any contract in which the Government bears the risk of cost overruns or underruns.

I do not agree that it is right to employ former contractor personnel in surveillance of the contractor's operations. I am aware that NAVSHIPS employs former contractor personnel in positions having engineering surveillance responsibilities over the activities where they were formerly employed. There are also a number of cases where former contractor personnel are working in the NAVSHIPS contracts division and where former NAVSHIPS contracting people work for shipbuilders. However, I do not consider such practice to be in the best interests of the Government. It may be that SUPSHIPS has violated no law or regulation in hiring more than 100 former employees of the contractor; it still seems to me a violation of common sense to place these employees in a position where they are expected to critically review the performance of their friends and former colleagues. The Navy must put a stop to this practice, particularly when the position being filled is directly concerned with the negotiation or administration of contract matters.

UNITED STATES
ATOMIC ENERGY COMMISSION
WASHINGTON, D.C. 20545

March 25, 1970

The Honorable William Proxmire
U. S. Senate
Washington, D. C.

Dear Senator Proxmire,

In our recent telephone conversation you requested that I write you a letter with my comments on remarks made by Mr. G. W. Rule concerning the Naval Nuclear Propulsion Program in his December 30, 1969 testimony before the Joint Economic Committee.

I have reviewed the transcript of the record of Mr. Rule's testimony and noted that in answer to your questions concerning the current large backlog of contractor claims against Navy shipbuilding contracts, Mr. Rule described the Nuclear Propulsion Program as having been conducted in a "claim breeding manner" and said that there are existing shipbuilder claims against the government because "unrealistic ship delivery dates were set when it was known or should have been known that the nuclear propulsion components for the ships would not be delivered to the yard in time to meet their delivery date."

Contrary to Mr. Rule's testimony there are no such shipbuilder claims.

Specifically Mr. Rule testified:

> "...in my looking ahead to areas of future claims I would be a great deal less than candid if I didn't mention to you an area that bothers me considerably and I have really, Senator Proxmire, wrestled with myself as to whether I should mention this area, but I cannot look ahead without seeing this area and, therefore, I want to mention it.
>
> ***
>
> ...what I am referring to specifically is the claim breeding manner in which we have contracted for some of our nuclear propelled vessels in the past.
>
> From claims now in being, claims that we have before us right now, it is obvious that contracts have been made where unrealistic ship delivery dates were set when it was known or should have been known that the nuclear propulsion components for the ships would not be delivered to the yard in time to enable the yard to meet their delivery date. The result: Claims, and we have them for that reason.

> If these practices are permitted to continue I predict substantial additional claims that the Navy will face from the construction of the CVANs, the DXGNs and other authorized nuclear vessels. It is very clear indeed to me that the Navy must be firm in its determination to not permit future contracts to contain unrealistic ship delivery dates as tested by the delivery dates of the nuclear component government-furnished material that goes into these ships...
>
> ***
>
> ...I, in my statement, sir, have to bear down on this question of late delivery of government-furnished material and primarily the nuclear components that go into these ships, because I know, I have cases in front of me where we have given a contractor a contract to turn out a ship or ships by a certain date, and he is tied to that contract, that date, and we don't supply the nuclear components in time for him to meet that date.
>
> Now, the minute we do that, the minute we miss that government-furnished material delivery date he has a claim. There is some thinking that he might work around a space where the component is missing from, and theoretically, I guess, this is true. But he has a claim, and what I don't want to see perpetrated is making these contracts with delivery dates that are known to be phony, when you know that the government-furnished propulsion machinery is going to be one year late, and we will make a contract and definitize the contract that we know is just asking for claims."

At the time Mr. Rule testified, the Navy had about 60 pending or anticipated claims under its shipbuilding contracts. These claims totaled about \$800 million. As you pointed out in your hearings, Mr. Rule is the chairman of a committee which was established to review these claims. A specific purpose of this committee is to maintain current information on the status of these claims. Thus, I would expect Mr. Rule to be well aware of the fact that nearly all of the pending or anticipated claims under Navy shipbuilding contracts--about 90% of the total--relate to construction of conventionally powered ships, not nuclear ships. Of the small fraction of the claims which relate to nuclear ships, only one claim, involving about \$8 million, relates to late delivery of nuclear propulsion plant equipment. The items involved in this claim were steam plant equipments--not nuclear components. They were delivered late because of supplier problems in manufacturing the equipment, and not because "unrealistic ship delivery dates were set when it was known or should have been known that the nuclear propulsion components for the ships would not be delivered to the yard in time to meet their delivery dates." No other shipbuilder claims for late delivery of equipment under my cognizance now exist under any of our shipbuilding contracts.

Even including the accelerated construction schedules for the Polaris submarine program, nuclear components have been delivered to support shipbuilding schedules with but a few, isolated exceptions where individual components have been delayed because of unforeseen circumstances, or where unexpected problems have developed after delivery of the equipment. Therefore, I do not understand the basis for Mr. Rule's prediction that the Navy will face substantial additional claims due to late delivery of nuclear components during construction of "the CVANs, the DXGNs, and other authorized nuclear vessels." His prediction is not supported by the historical record. Moreover, the contracts for constructing the CVANs, the DXGNs, and the recently authorized new design submarines have not yet been finalized. The Navy's plans for finalizing these contracts take into consideration the current status of all government and contractor furnished material and design information and include provision for structuring the contracts so as to minimize the possibility of shipbuilder claims arising from late government furnished material or government furnished design information. These plans were discussed with Mr. Rule prior to his testimony before your Committee.

Of course, many problems have arisen during the construction of about 100 nuclear powered submarines and surface warships--ships which have incorporated rapid advancements in technology. Some of these problems have inevitably led to delay in delivery of components and in some cases higher costs of ship construction. I have had to face these problems as they occurred and have had to take whatever action was in the government's best interest according to the circumstances at the time. The timely accomplishment of any complex technical project requires a balancing of risks. Inevitably these risks lead occasionally to delays and higher costs due to unexpected problems which arise as the state-of-the-art is advanced.

NIMITZ Class Attack Carrier Program

I would like at this point to discuss in some detail the NIMITZ class aircraft carriers because that program illustrates some of the points I have just made.

In mid-1964 the Secretary of Defense requested the Atomic Energy Commission to develop a two-reactor nuclear propulsion plant suitable for the NIMITZ class carriers, the first of which was to be included in the 1967 shipbuilding program. It was recognized at the outset that the transition from the eight-reactor plant with a 3-year reactor core life then installed in the ENTERPRISE to a two-reactor plant of about the same total power with a 13-year reactor core life would be a major technological advance. It was also recognized that the first-of-a-kind equipments needed for the two-reactor plant would be the largest ever manufactured for the Naval Nuclear Propulsion Program. Because of the long leadtime required to procure the large, new-design reactor components, and because their delivery controls the ship construction schedule, the Navy in the fall of 1964 requested that advance procurement funds be provided in the FY 1966 budget for the FY 1967 carrier--the NIMITZ, CVAN68. However, the Department of Defense did not accept this request and decided that all shipbuilding funds for the CVAN68 should be included in the fiscal year 1967 shipbuilding program. The initial shipbuilding funds for the CVAN68 thus were made available to the Navy in July 1966, one year later than the Navy requested to support its desired completion date for this ship.

Due to the difficulty encountered in obtaining adequate industrial support to manufacture the nuclear propulsion plant components on a schedule supporting the NIMITZ construction schedule, the Naval Ship Systems Command in 1967 obtained approval to assign the highest industrial priority to the NIMITZ propulsion plant. This propulsion plant is being procured on a very tight schedule through four prime contractors, about fifty major suppliers and over one-thousand sub-tier contractors.

Procurement of nuclear propulsion plant equipment for the NIMITZ is now well into the production phase. Delivery of the first of the nuclear components has taken place. Completion of all nuclear propulsion plant component deliveries is expected in 1972. Many of the large nuclear propulsion plant components will be delivered and installed this year. However, solution of development and production problems including labor strikes in several factories has delayed some components so that delivery of the NIMITZ will probably be extended from 1972 to 1973.

Nuclear propulsion plant components for the second carrier of the class, the DWIGHT D. EISENHOWER, CVAN69, will come off production lines right after components for the NIMITZ and will therefore be in time to support the construction schedule for the EISENHOWER. However, since the two ships are being constructed in series in the same shipyard and have to use the same limited drydock and pierside facilities, delay in the NIMITZ could also delay the EISENHOWER. The Naval Ship Systems Command is working with the shipbuilder to arrange the shipbuilding schedules so as to build both ships at minimum cost.

The NIMITZ is presently scheduled to be delivered to the Fleet in 1972 and the EISENHOWER in 1974. As I indicated above, these schedules may be delayed about a year. If the Congress approves the Department of Defense FY 1971 budget request for advance procurement funds for the third NIMITZ class carrier, the CVAN70, and fully funds that carrier in FY 1972, it is expected to be delivered to the Fleet in 1977, even considering possible delays in the first two ships.

The Navy thus considers it necessary to proceed with advance procurement for the CVAN70 in FY 1971 as presently planned, not only to prevent further delay to the ship, but also to avoid having to shut down the special production lines which have been established specifically to manufacture the nuclear components needed for NIMITZ class aircraft carriers. In this regard, it should be remembered that procurement of long lead material for the EISENHOWER was started in July 1967. Even with FY 71 advance procurement funding, we are not able to initiate procurement for the CVAN70 until July 1970 at the earliest-three years after start of procurement for the EISENHOWER.

From the above discussion, I am sure you can appreciate that the development, procurement and delivery of nuclear components must be carefully planned and funded to take maximum advantage of technological advances, to obtain the necessary industry capacity, and to meet shipbuilding schedules. It is not simply a matter of ordering components to be delivered by a specified date.

DXGN Nuclear-Powered Guided-Missile Frigate Program

With respect to the nuclear-powered guided-missile frigate DXGN program (now called the DLGN38 class), all nuclear components are presently expected to be delivered in time to support orderly ship construction for those ships for which funds have been appropriated.

High Speed Nuclear Attack Submarine Program

The original schedules set over a year ago for our new design high speed submarine program (SSN688 class) were predicated on the premise that the highest industrial priority would be assigned to this program. However, the Navy has not yet been successful in obtaining approval for such a priority, although the Department of Defense recently agreed to seek approval of this priority for selected items on the first ship of the class. As a result, the submarine delivery schedules have recently been revised to reflect the time that has elapsed without this priority. As noted above, our contracting plans take into consideration the current status of all Government and contractor furnished material and design information. Therefore this delay in ship deliveries will be accommodated in initial ship contracts and will not be a valid basis for shipbuilder claims. It will however, result in somewhat higher ship costs due to inflation occuring during the delay.

I hope that the information in this letter will help to clarify the record concerning naval nuclear propulsion matters. If you have questions or desire amplification of any point I have made, please do not hesitate to ask.

Please know that I deeply appreciate the support you have given over many years to the Naval Nuclear Propulsion Program.

Respectfully,

H. G. Rickover

UNITED STATES
ATOMIC ENERGY COMMISSION
WASHINGTON, D.C. 20545

May 28, 1970

The Honorable William Proxmire
U. S. Senate
Washington, D. C.

Dear Senator Proxmire,

On May 1, 1970, you sent me copies of your March 17, 1970 letter to the Secretary of Defense and the Defense Department's response dated April 21, 1970. Your March 17th letter raised several questions concerning the lack of industry compliance with the Truth-in-Negotiations Act. The questions were based on my testimony and that of other witnesses before the Joint Economic Committee. Your May 1st letter asked me to comment on the Defense Department's official response.

I can appreciate your concern. The Defense Department's response appears inconsistent with testimony I have given before various Congressional committees, including your own. I have testified on several occasions that the Truth-in-Negotiations Act has not been implemented effectively by the Department of Defense and that entire segments of industry, such as computer manufacturers, material suppliers, and others, appear to be taking a united stand in refusing to provide cost and pricing data required by the Act. The Department of Defense, however, responded that, generally speaking, defense contractors and subcontractors have provided cost or pricing data when required by Public Law 87-653 except in selected cases; that, with the exception of two firms, the Department does not know of any industries or companies that refuse across-the-board to provide cost and pricing data; and that since the passage of Public Law 87-653, the Department of Defense has entered into well over 100 thousand transactions which were subject to the Act with only a minuscule number of waivers--all of which were reviewed at high levels in accordance with administrative procedures.

The Department of Defense also stated it was always seeking improved methods of administering the Truth-in-Negotiations Act; that a task group had been recently created to study alleged contractor resistance in supplying cost and pricing data in specific instances; and that the Department would take actions as necessary to improve its implementation of this law.

In stating that only a small number of waivers to the Truth-in-Negotiations Act have been granted, the implication is that all but this small number have been in compliance with the Act. The real issue, however, is the very large number of procurements, both prime contracts and subcontracts, where the law has not been complied with.

With regard to the Defense Department's response:

1. It is incomprehensible to me that defense procurement officials do not know of any industries or companies, other than the two specifically mentioned, that refuse across-the-board to provide cost and pricing data.

2. I believe, in light of the large segments of the defense industry that have been refusing to comply with the Truth-in-Negotiations Act, that the small number of waivers granted by the Defense Department is evidence it has failed to police the Act.

3. It appears that defense procurement officials have been placing too much reliance on management systems rather than actually checking into its procurement operations to identify problems. The establishment of a special task group at this late date to study "alleged contractor resistance to supplying cost or pricing data in specific instances" is indicative of the extent to which defense procurement officials have insulated themselves from actual procurement problems. Contractors in a number of industries have not been providing cost and pricing data since 1962--the year of enactment of the Truth-in-Negotiations Act.

The refusal of industries and companies to provide cost and pricing data in accordance with the Truth-in-Negotiations Act is known to officials of other Government agencies and to those involved in day-to-day procurement. I do not understand why the Defense Department does not face up to this problem. The following are three specific industries I have encountered that have not been complying with the requirements of the Truth-in-Negotiations Act:

a. Computer Industry

Computer suppliers have not been providing cost and pricing data to the Government as required by the Truth-in-Negotiations Act. Defense procurement officials should know of the problem; the Department of Defense has waived the Truth-in-Negotiations Act in connection with computer procurements. The issue has been well documented within the Government.

I pointed out this particular problem in testimony to Congress for the past several years. The Administrator of the General Services Administration also raised this issue in Congressional hearings and took it up with the General Accounting Office. The Atomic Energy Commission recognized this problem, too, and has been working with the Bureau of the Budget and the

General Services Administration to try to get it resolved. The problem is a matter of concern at the highest levels within the Atomic Energy Commission, as is evident from the following statement from a recent Atomic Energy Commission staff paper concerning failure of computer manufacturers to comply with the Truth-in-Negotiations Act:

> "In summary, the problem has been brought to the attention of the Congress and the General Accounting Office, to the attention of the Government's central ADPE procurement agency (GSA), and to the attention of the Bureau of the Budget. We have received a great deal of sympathy, but no solution. It would appear, therefore, that in the absence of getting the law amended either (1) to make submission of cost or pricing data mandatory, with penalties for failure to do so, or (2) to exempt computers from the present requirements of the law, we have no alternative but to continue waiving the requirement for cost or pricing data on a case-by-case basis."

b. Material Suppliers

Raw materials, particularly steel, are another example where an entire industry has not been required to comply with the Truth-in-Negotiations Act. Despite the many special purpose materials developed and procured strictly for military application, very few material suppliers have been required to provide cost or pricing data. Because material procurements often take place at the second, third, or lower level of subtier supplier, non-compliance with the Act in the area of material procurement is less apparent than it is in the case of computer procurements. However, a little checking would show that material suppliers generally do not provide cost and pricing data in accordance with the Act.

I found that in some cases considerable effort and ingenuity have gone into finding ways to circumvent the law. Here are some ways defense contractors and Government officials have been able for 8 years to procure materials from companies that refuse to comply with the Truth-in-Negotiations Act without having to obtain an official waiver of the law:

1. Determine that two or three bids constitute adequate competition regardless of the circumstances.

   The Truth-in-Negotiations Act provides that supplier cost and pricing data are not required if the procuring activity considers competition to be adequate. Since this judgment is often based on subjective and intangible factors, it is subject to considerable abuse.

Procurement of HY 80 and HY 100 armor plate for shipbuilding is a good example. These specialty steels were developed at Government expense and are used almost exclusively in the construction of nuclear submarines and other naval vessels. In 1965 the General Accounting Office issued a report on Navy procurement of HY 80 steel pointing out that the limited competition available did not insure reasonable prices; the two suppliers were making profits of 14 to 27%. The Navy replied that, in future, the Navy and its prime contractors would discontinue procurement of this material by formal advertising and would obtain certified cost and pricing data as required by the Truth-in-Negotiations Act.

In December, 1969, I pointed out to Navy officials that shipbuilders had not been obtaining cost and pricing data on HY 80 and HY 100 steel procurements despite the assurances the Navy had made to the General Accounting Office. Further, it turned out that responsibility for direct Navy procurements of this material had been assigned to the Defense Industrial Supply Center. This Center had not insisted on cost and pricing data either. The shipyards and the Defense Industrial Supply Center had decided that competition was adequate and that no cost and pricing data were required.

The fact is that no one has yet been able to obtain the steel companies' agreement to provide such data. The Navy is now working on this problem; I understand that as of this date all the steel suppliers still refuse to provide cost and pricing data on these procurements.

2. Conclude that the price is based on standard catalog prices.

The Truth-in-Negotiations Act provides that supplier cost and pricing data need not be obtained where prices are negotiated based on established catalog or market prices of commercial items sold in substantial quantities to the general public. Material suppliers, therefore, establish standard catalog prices for the basic material, and separate add-on factors for additional specification requirements. The result is that prices for specialty materials peculiar to defense equipment can be "based on established catalog or market prices of commercial items sold in substantial quantities to the general public". The Truth-in-Negotiations Act is thereby avoided.

3. Break procurements into small orders that do not exceed $100,000.

Procurements under $100,000 are exempt from the Truth-in-Negotiations Act. As a result, some contractors divide their total requirements into several smaller orders to bypass the Truth-in-Negotiations Act. I found that a shipbuilder recently procured on a sole-source basis $3.4 million of specialty steel for a single ship under 1200 separate purchase orders, none of which exceeded $100,000.

4. Disregard the law and chance that no one in the Government will find out.

This tends to be encountered more in the second or third tier subcontract level. However, in 1969, I found that two of the Navy's major shipbuilders, most of whose government business is under Navy prime contracts, had not implemented the Truth-in-Negotiations Act seven years after its enactment.

c. Forging Suppliers

For years the Department of Defense and its contractors have been buying specialty forgings without obtaining cost and pricing data from forging suppliers. The forgings are bought on the basis that there is "adequate competition" for such items and that this "competition" can be relied upon to insure reasonable prices to the government; therefore cost and pricing data are not required. In fact, there is not usually real competition for such forgings. What limited competition there is usually is not adequate to insure reasonable prices. For example, frequently only one or two suppliers are able to make the item, and often one supplier has a significant competitive advantage over the others in the form of production facilities or by virtue of having obtained the initial order which paid for the tools, dies and fixtures needed for the forgings. Often there is only one source.

I recently brought four specific cases involving sole-source procurements to the attention of senior defense procurement officials. Since sole-source procurement were involved, there was no question as to whether or not competition was adequate; cost and pricing data were clearly required in these procurements.

In these four cases, each of the four forging companies stated that its policy was to not provide cost and pricing data. Navy procurement officials had to devote considerable time and effort trying to convince these companies--8 years after enactment of the Truth-in-Negotiations Act--that they should start complying with the law. The results were less than satisfactory but they were the best the Navy could obtain in the circumstances without further jeopardizing project schedules. The following is a summary:

SUPPLIER	TIME SPENT TRYING TO GET AGREEMENT TO PROVIDE COST DATA	FINAL RESOLUTION
Forging Supplier A	2 months	Forging Supplier A refused to provide cost data. The Assistant Secretary of the Navy had to waive the law to avoid delay to an important project.
Forging Supplier B	6 months	Forging Supplier B finally agreed to provide cost data, on this one procurement only, on the basis that the Navy could get no bids from another source. The cost data showed an unsupported contingency factor such that the supplier stands to make a 23% profit on this order. The supplier, however, has refused to reduce his price.
Forging Supplier C	7 months	The Government had to agree to a cost-type contract rather than a fixed-price contract before Forging Supplier C would agree to provide cost and pricing data on this procurement. The Government is left with the problem of administering a cost-type contract through two higher tiers of contractors, one of which is operating under a fixed price order. This is not an acceptable long-run solution to the problem.
Forging Supplier D	7 months	Shortly after a member of Forging Supplier D's management was appointed to the Holifield Commission on Government Procurement, the company provided cost data. These data are being audited. Since then, however, Forging Supplier D has been unable to obtain the required cost and pricing data from its traditional steel supplier on an order for steel to be used in the Navy forgings. Forging Supplier D is now seeking a bid from another steel supplier so that his lower tier procurement of steel can be classified "competitive".

I find it hard to believe that the problems I have pointed out are unique to my area of responsibility which covers but a small fraction of Defense Department procurement. Computers, steel, and forgings are basic to most military hardware. Therefore, I can only conclude that a general laxity in the implementation and enforcement of the Truth-in-Negotiations Act pervades the defense procurement establishment. It would appear to me that, if the issue were thoroughly investigated, it would be found that the problem is endemic throughout defense procurement. Of course, if you don't follow the facts too closely you won't have dirt kicked in your face.

As I have testified many times, I believe the Department of Defense should face up to the lack of effective competition in contracts and subcontracts for complex defense equipment and implement the Truth-in-Negotiations Act. Moreover, I believe it is wrong to apply a double standard such that some favored industries and companies are allowed to avoid the Truth-in-Negotiations Act, while others must comply. I believe you will find that my testimony to this effect is based on fact.

I trust the above is responsive to your letter.

Respectfully,

H. G. Rickover

H. G. RICKOVER

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-767
15 July 1970

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS & LOGISTICS)

Via: (1) Commander, Naval Ship Systems Command
(2) Chief of Naval Material

Subj: Review of Overhead Costs on Navy Contracts at Electric Boat

Ref: (a) NAVSHIPS ltr OON:FCJ:LT Serial 124-OON dtd 30 April 1970

Encl: (1) Report on Overhead Costs on Navy Contracts at Electric Boat

1. On several occasions during the past two years, I have written to you regarding contractor procurement and cost control deficiencies which are resulting in unnecessary costs to the government at our major private shipyards.

2. Enclosure (1) is a report concerning the administration and charging of overhead costs on Navy contracts with Electric Boat. As in the case of procurement and cost control, it appears that the government is paying far more than it should in overhead costs at Electric Boat, and that the government is not effectively administering its contracts with Electric Boat. In total, from reviews conducted to date, I believe the government could reduce its shipbuilding costs by 5 to 10 percent--$10 million or more per year at Electric Boat alone--by improved administration of its contracts and by improved contractor management practices.

3. Enclosure (1) points out that the flexibility in Electric Boat's accounting system precludes either Electric Boat or the government from ensuring that costs are charged fairly between cost-type and fixed-price-type contracts. It appears that this accounting flexibility results in overcharges to government cost-type contracts.

4. Enclosure (1) indicates that General Dynamics' corporate policies with respect to corporate investment, lease versus purchase, and proprietary purchases may also be resulting in higher than necessary overhead costs at Electric Boat. The company seems to follow a policy of minimizing corporate investment in the shipyard even though this leads to higher operating costs. Corporate investment in plant and facilities at Electric Boat in each of the past three years has declined about 8 to 10 percent a year. Moreover, the use of obsolescent shipyard facilities leads to higher labor costs and other inefficiencies. The company, however, is able to pass on the higher operating costs directly to the government because nearly all recent government contracts have been placed on a noncompetitive basis.

5. The specific examples cited in enclosure (1) are not meant to be exhaustive. Rather, they are illustrative of a general problem concerning overhead costs at Electric Boat and other private shipyards.

6. Enclosure (1) provides additional evidence that the Navy is not administering its shipbuilding contracts properly. In this regard, I hope that those responsible for administering our shipbuilding contracts will respond to this report by developing more effective controls. Such action would be considerably more constructive than the pattern of responses to my previous reports. In the past, the response has been that my facts are wrong, my conclusions in error, and that there is no substance to the issues I have raised. When further investigation confirms the deficiencies, those in charge then claim the deficiencies are minor, that corrective action was underway before I raised the issue, and that there is no need for further concern. The result, intentional or otherwise, is to obfuscate important issues.

7. In March,1970, you asked the Chief of Naval Material to establish a special review team to look into the procurement and cost control issues I raised. The review team's report, reference (a), replaces my term, "major deficiencies",with the phrase: "significant areas for improvement". Then, at great length, the report comments on the details of my examples, often to the exclusion of the basic issues themselves. At one point, the review team devotes eight pages of comments to a single sentence in my report; their conclusion is that I was right, but that the particular problem "is not representative of a general condition". How much more germane and valuable it would have been if all that time and effort had been devoted to reducing government costs at Electric Boat.

8. In response to my reports, your special review team and NAVSHIPS have attributed the lack of effective contract administration at our major shipyards to a Department of Defense policy of "disengagement". The team asked you to "set forth the applicability of the so-called DOD disengagement policy to Navy contractors such as Electric Boat". I have never been able to find any policy directives on "disengagement". However, the references to this policy in NAVSHIPS' correspondence indicate that the government is relying totally on the contractor to spend government funds prudently.

9. My years of experience in dealing with defense contractors have proved time and again that the government cannot afford to delegate its responsibility to contractors. Government officials have an unassignable responsibility to the taxpaying public to ensure that, when public funds are involved, contractors procure materials economically, maintain effective controls over production and overhead costs, charge costs fairly, and so on. The shipyard conditions which I have been pointing out for nearly two years are further evidence that defense contractors cannot and should not be expected

to act in the public interest. Thus, I strongly urge that you plainly and forthrightly state there is no such policy as "disengagement" at other shipyards or anywhere else where government funds are being spent.

10. The situation facing the Navy today is that we cannot get Congress to give us the money for the ships we need because of their high cost. Yet at the same time loose Navy contracting practices are contributing to the high cost. We ourselves are much to blame. The Navy prefers to emphasize what is right with shipbuilding, but what is right will not last if we do not correct what is wrong. We must face up to the real situation, painful or not, and quickly. We must take drastic action to improve our administration of shipbuilding contracts, require our contractors to operate their shipyards more efficiently,and begin to regain credibility with Congress and with the public.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Assistant Secretary of the Navy (Installations & Logistics)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-772
26 August 1970

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Deficiencies in Procurement and Cost Control Practices of the Electric Boat Division, General Dynamics Corporation; comments on NAVSHIPS Investigation of

Ref: (a) NAVSHIPS ltr OON:FCJ:LT serial 124-OON dtd 30 April 1970
(b) NAVSHIPS endorsement 07B:JRN:NO serial 14-07B dtd 10 June 1970 on Deputy Commander for Nuclear Propulsion memo 08H-718 of 19 February 1970
(c) Deputy Commander for Nuclear Propulsion Memorandum to the Assistant Secretary of the Navy (Installations & Logistics) serial 08H-718 of 19 February 1970

Encl: (1) Comments on Navy Department Review Team Report dated 30 April 1970 on Electric Boat Procurement and Cost Control Practices and on COMNAVSHIPS endorsement dtd 10 June 1970

1. Reference (a) is the report of the special Navy Department Review Team that was established at your request to investigate procurement and cost control practices in March 1970 at Electric Boat. This special review was initiated as a result of my reports which pointed out many serious deficiencies in Electric Boat Division cost control and procurement practices under Navy ship design, construction and overhaul contracts. I also stressed the need for significant improvements in administration of Navy shipbuilding contracts at Electric Boat. Reference (b) is a COMNAVSHIPS endorsement which forwards the Team Report and comments both on the Team Report and on my memorandum to you of 19 February 1970, reference (c).

2. The Team Report substantiates many of my conclusions concerning the need for improvement in procurement and cost control practices at Electric Boat. However, the Team Report states:

> ". . .while there are significant areas for improvement in EB's procurement and cost control practices, as shown in the body of this report (and to this extent NAVSHIPS 08 is supported in its overall conclusion concerning EB) many of the examples cited and the findings made are not supported by a thorough evaluation of the facts. In a number of instances it is apparent that only a superficial investigation by NAVSHIPS 08 was made, resulting in conclusions which the facts do not warrant."

In reference (b) COMNAVSHIPS expresses agreement with the above statement.

3. I have carefully reviewed each example or finding which the Team contends is not supported by a "thorough evaluation of the facts". My review shows exactly the opposite: The examples and findings cited in my reports appear well supported by the facts. In addition:

a. The Naval Material Command Contractor Procurement Review Team Report issued January 1970 confirms the existence of serious deficiencies in Electric Boat procurement practices.

b. The Defense Contract Audit Agency Report issued August 1970 confirms the existence of a major problem with respect to Electric Boat's mischarging of labor costs, thus refuting the same auditor's denial of several months ago that any problem existed.

c. The internal Defense Contract Audit Agency memoranda and the Navy Review Team's Report, reference (a), confirm that there is a major deficiency in the contractor's system for controlling costs of materials charged to Government contracts.

d. COMNAVSHIPS and the Navy Review Team Report confirm that Electric Boat is obtaining progress payments from the Government on its inventories before the material is issued for use and even before the contractor has paid for it. However, COMNAVSHIPS and the Navy Review Team consider this practice acceptable.

e. Defense Contract Audit Agency correspondence with the contractor subsequent to my report confirms that the Government was not being given access to certain records required for adequate administration of its contracts at Electric Boat.

f. COMNAVSHIPS confirms that there is no segregation and accounting for the cost of change orders, and a Defense Contract Audit Agency Report issued in July 1970 concluded that the contractor's estimating system, upon which the Government is forced to rely, is not adequate for Government contracts.

4. Despite this record, which clearly supports the findings in my reports to you, the Navy Department Review Team devoted considerable effort to discrediting my statements. The Team report contains 98 pages of comment on my findings and examples. These comments generally defend Electric Boat

actions and refer to my statements in terms such as the following:

". . . do not completely portray the total situation".
". . . does not tell the full story".
". . . is not factually correct".
". . . the complete story is less simple".
". . . is not representative of a general condition".

I find a strong bias in the Team comments, a bias defensive of NAVSHIPS and of the contractor.

5. The Team Report frequently does not discuss the issues I raised. Rather, it focuses on details of the examples I cited to illustrate the issues. In some cases the Team appears to have missed the point illustrated by the example. In others, the Team Report omits mention of significant facts derogatory to Electric Boat or to Government performance, but cites at length justifications for Electric Boat or Government actions. In at least one case the Team comment appears to have been prepared by the contractor. The Team's comments frequently obfuscate the issue through a lengthly discussion which emphasizes the adequacy of Electric Boat practices and procedures. For example, the Team devotes a full chapter--17 pages--to refuting my comments concerning mischarging of labor costs. Only in the third appendix to the report can the reader learn that a recent floor check by the Government auditor showed a 32% error rate and a potential mischarging of 20 percent.

6. Enclosure (1) contains my detailed comments on the Review Team Report.

7. It has been more than a year since I first brought these basic issues to the attention of senior Navy officials. I am deeply disappointed in the Navy's actions to date. Navy officials have written hundreds of pages evading the issues and defending their inaction; they have done almost nothing to improve the situation. Their reaction is typical of a bureaucracy. When the functioning of any part is criticized, its constituency feels compelled to rise in defense of all its practices.

8. It would seem to me that if there were but one meritorious criticism in my reports, those responsible for administering our shipbuilding contracts should have asked themselves: "Why has this situation obtained for so long and why did I not know about it? Why did someone else have to point it out to me?" Instead, they have adopted the well known tactic of shifting the blame to the critic; to place him on the defensive. It reminds me of the Persian kings who were wont to cut off the head of messengers bearing bad news.

9. In its conclusions, the Navy Review Team Report paints an encouraging picture: there are some problems, but the contractor is cooperative; the problems that do exist are being addressed and will soon be resolved; the contractor has progressed substantially in implementing the Naval Material Command procurement system review recommendations.

10. I, on the other hand, am not encouraged by these reports. Outside of some "paper changes", i.e., organizational reshuffling, procedure rewriting, etc., little has been done to improve procurement and cost control practices at Electric Boat. Nothing appears to have been done to improve the Navy's administration of its contracts.

11. Particularly disturbing to me is the NAVSHIPS suggestion in reference (b) that we have no right to efficient performance or proper charging under our contracts:

> "I agree with the overall conclusion of the Review Team, contained in Appendix III page A-III-I and quoted below, provided it is recognized that the improvements recommended are beyond the requirements of existing contracts." [Emphasis added]

It seems to me that any customer--including the Government--has a right to expect economical and efficient performance--and proper charges--from his contractors. It is also true that most contractors will give their customers less than they contracted for if the customer will accept less.

12. From the NAVSHIPS responses to date, I see no hope of ever improving administration of our shipbuilding contracts through existing organizations. Therefore, I recommend that you take action with the Chief of Naval Material to institute whatever new organizational relationships are necessary to obtain proper administration of these contracts.

13. The Navy must make a choice: it can take firm steps now to demand and obtain acceptable performance by its contractors and to provide for proper administration of our shipbuilding contracts, or it can allow these problems to drag on until the General Accounting Office or Congress requires the Navy to take action. I am sure you understand the importance to the Navy of setting its own house in order without being forced to do so by an outside agency or by Congress.

14. I am more than disturbed at the constant effort by the very people who have been responsible for the faults I discovered to talk them away. It is discouraging that so many officials in the field and at headquarters will not face up to facts; apparently they will have to be hit by a sledge-hammer. At the slightest sign of "improvement" they become euphoric and say: "See, it

wasn't that bad at all, and even if it was bad, the company has now reformed itself." They then go about "business as usual", which means going back to doing little or nothing about the basic issues.

15. Further, they seem to be incapable of taking actions based on principles; they tend rather to cure only the examples which illustrate the principles. Or else they are always seeking for precise rules to solve imprecise situations--in other words they act as clerks, not as officials. Example: The suggestion by the Navy Review Team that the Armed Services Procurement Regulations be modified to specify the desired level of accuracy for labor charges on Government contracts.

16. I have entered into this series of criticisms because the way the Navy is doing business is wasteful of Government funds and therefore does not permit us to build as many ships as we otherwise could. My object is not the vain effort to make contractors live up to their contracts with proper accounting, procurement and cost control practices, or to make Government officials do the jobs they are paid to do. It is to obtain the maximum defense possible for the United States.

H. G. Rickover
H. G. RICKOVER

Copy to:
CNM
COMNAVSHIPS

NAVSHIPS 08 Comments on Navy Department Review Team Report Dated 30 April 1970 on Electric Boat Procurement and Cost Control Practices

Electric Boat Procurement Practices

1. Problem and Recommendations, as stated in NAVSHIPS 08 Report Dated 13 September 1969:

> ". . .there are widespread weaknesses and deficiencies in Electric Boat procurement practices."

* * *

> "Subcontracted work accounts for about one-third of the construction costs of a nuclear submarine. In 1968 the Electric Boat procurement department awarded subcontracts in the amount of $53 million. So far in 1969, Electric Boat is subcontracting at an annual rate of about $86 million. A review of about 40 procurement files revealed numerous deficiencies and fundamental weaknesses in Electric Boat's procurement procedures and practices. The deficiencies in procurement practices were common and widespread. The Government could save substantial sums by simply requiring Electric Boat to improve its procurement practices."

* * *

> "[The Navy should] withdraw approval of the procurement system. The company should be required to submit all proposed subcontracts in excess of $25,000 for Government review and approval prior to placement."

2. Contractor Procurement System Review Team Report (CPSR):

A Contractor Procurement System Review Team (CPSR) in October 1969 (report issued January 1970) confirmed existence of the basic deficiencies in Electric Boat procurement practices outlined in NAVSHIPS 08 report of 13 September 1969. The CPSR Report stated:

> "This initial review disclosed that the contractor's procurement system is inadequate, fails to afford maximum protection of the Government interest and does not assure procurement of materials at the lowest price consistent with quality and required delivery schedules."

The CPSR Report was included as Appendix 2 to the Navy Department Review Team Report.

3. Navy Department Review Team Report:

The Navy Department Review Team Report stated:

"Review of the Purchasing Department's files and interviews with EB personnel disclosed areas of improvement since the CPSR. These areas included (i) the percentage of cases in which negotiations were considered to have been performed effectively (31 percent in the October CPSR vs. 36 percent observed during this review) and (ii) the percentage of cases in which EB's own resources were used effectively for price/cost analysis (77 percent in the October CPSR vs. 83 percent observed during this review). In addition, the current Review Team considered the purchase orders reviewed to be satisfactory overall for 83 percent of the cases as opposed to 74 percent observed during the October 1969 review. Moreover, EB has instituted action (e.g., controlled bid procedures and establishment of a cost/price analysis group) to implement all of the CPSR recommendations addressed to them. Due to the nature of some of the recommendations and the relatively short time which EB has had in which to implement them, it is still too early to test the total effectiveness of the actions taken to implement the CPSR recommendations. However, if EB continues with the vigorous approach currently being utilized, it should be in a position by no later than October 1970 for a complete reevaluation of its procurement system. Electric Boat Division does not have a standard index (Table of Contents) for its purchase order files, nor does it have an established Procurement Review Board to review sole/single source procurement."

4. NAVSHIPS 08 Comment on Navy Review Team Report

While acknowledging existence of basic procurement deficiencies at Electric Boat and the need for corrective action, the Navy Department Team Report proceeds to criticize the statements of findings in the NAVSHIPS 08 13 September 1969 report.

NAVSHIPS 08 comments on each item in the Navy Review Team Report concerning NAVSHIPS 08 findings are contained in the following pages.

NAVSHIPS 08 Finding - 1

1. NAVSHIPS 08 13 September 1969 Report:

Procurement files do not adequately justify prices being paid by Electric Boat:

> "Of the 40 procurement files reviewed, there was no evidence of actual return cost information from prior orders being used to justify proposed costs. Electric Boat is not using pre-award audits or detailed independent estimates to evaluate, negotiate and justify prices in sole-source and other non-competitive procurements as required by the Armed Services Procurement Regulation."

2. Contractor Procurement System Review Team Report (CPSR):

The January 1970 CPSR Report confirmed the NAVSHIPS 08 statement that Electric Boat procurement files do not adequately justify prices being paid. The CPSR Report stated:

> "In addition to the foregoing, the review also disclosed that for the total of 148 purchase orders reviewed 45 were inadequately documented. These inadequacies included incomplete data supporting the Certificate or Current Cost or Pricing Data, no way to determine estimated portion from factual data, lack of audit, no cost breakdown for inter-divisional transactions (DD Form 633 or other), lack of written record of negotiations and lack of record of previous buys. All of the above plus other documentation discrepancies are in direct violation of Electric Boat Division's Procurement Management Directive No. 61 which requires each file to be self-explanatory. It was also noted that some files contained incomplete records of cost analysis and records of negotiations."

3. Navy Department Review Team Report

The Navy Department Review Team Report does not comment on the NAVSHIPS 08 finding, but only on the examples cited in support of the finding. The Team Report stated:

"The specific examples cited [by NAVSHIPS 08] to illustrate this deficiency do not completely portray the total situation nor identify by purchase order number the procurements reviewed. In-depth reviews during the October 1969 CPSR and this current review of procurement of shaft seals and pumps disclosed the following:"

* * *

The Team Report then proceeds to comment at length on the details of the examples citing justification to defend Electric Boat actions in the procurements.

4. NAVSHIPS 08 Comment

Despite the extensive comments and discussion in the Review Team Report in justification of Electric Boat actions, the examples cited by NAVSHIPS 08 show:

a. Electric Boat placed sole source orders for shaft seals for several years without obtaining and reviewing actual costs on prior orders to insure reasonable prices to the Government. When the Government auditor finally checked one order, he questioned 30% of the price. Clearly Electric Boat should have been obtaining and reviewing supplier cost and pricing data instead of relying on price justifications based on its original 1964 procurement.

b. Electric Boat proposed to place a sole source order totaling over $500,000 with one of its principal suppliers but without obtaining cost and pricing data required by the Truth-in-Negotiations Act and the Armed Services Procurement Regulation. In checking this procurement the auditor questioned more than $230,000 out of $500,000 price. The NAVSHIPS 08 September 1969 Report noted this matter was still pending; it has not yet been settled.

The Team Report notes that Electric Boat has since reached agreement with its supplier to obtain certified cost and pricing data where required in future procurements. However, in neither of the above cases did Electric Boat files contain documentation to support the reasonableness of the prices paid by Electric Boat.

NAVSHIPS 08 Finding - 2

1. NAVSHIPS 08 13 September 1969 Report:

> "There seems to be an excessive and unwarranted amount of sole source procurement. It appears that many of these sole source procurements have been overpriced."

2. Contractor Procurement System Review Team Report (CPSR):

> "The CPSR team's evaluation of contractor files shows that 66.9% of the subcontracts examined have been awarded to single/sole source (i.e. 99 subcontracts, so awarded, divided by the 148 subcontracts sample equals 66.9%). Further, this evaluation shows that 79.9% of the dollar volume (i.e. $12,819,172 divided by $16,047,687 equals 79.9%) has been involved in awards to single/sole sources. In comparison and according to a monthly report by the Purchase Department, approximately 66.5% of the total procurement dollars cumulative through June 1969 have been placed on other than a competitive basis."

3. Navy Department Review Team Report

The Team report comments that subsequent to the October 1969 CPSR, Electric Boat has prepared an interim instruction setting forth criteria to be used, justifications to be required, and approvals to be obtained for sole source procurements.

With regard to NAVSHIPS 08 statement "it appears that many of these sole source procurements have been overpriced", the Team comments at length on three examples from the NAVSHIPS 08 September 1969 report, citing Electric Boat's justification of its continuing sole source procurement of shipboard furniture from a "middleman", its continuing sole source procurement of valve actuators despite lower bids and quotations from other firms, and its "add-on" procurement of steel without obtaining competitive quotations. These Team comments are summarized briefly below:

a. Shipboard furniture   The Team Report states that in 1966 and 1967 Electric Boat attempted without success to obtain competition for for shipboard furniture. Because of the sole source situation Electric Boat required DCAA to make a pre-award government audit in connection with this procurement. The Report states:

"Although sole source situations are never desirable, and by their nature are risky, from a cost stand point, there is no demonstrated basis for arriving at the conclusion 'it appears that many of these sole source procurements have been overpriced', with respect to the procurement of furniture from R.L. Hanson, Inc. The General Dynamics audit scheduled for June 1970 will provide Electric Boat Division with a valid basis for assuring that final prices paid are reasonable.

With respect to the DCAA Audit report mentioned in connections with the allegation, use of the report is misleading in that it is incomplete and therefore could not be used for its intended purpose of assisting in the establishment of reasonableness of quoted prices. Electric Boat Division obtained from SUPSHIP Groton consent for award to R. L. Hanson on 19 November 1969 (SSN 678-684)."

NAVSHIPS 08 Comment

The Navy Review Team comment is misleading:

1. Electric Boat has been procuring shipboard furniture sole source for many years. The first government "pre-award" audit was requested in April 1969, four months after the firm fixed price order discussed in the Team Report was placed. The purchase order in Electric Boat files did not contain a written provision for a downward price adjustment based on a government audit.

2. There are other sources for shipboard furniture. Newport News and Ingalls have obtained lower prices through competitive bidding. In a recent shipyard solicitation (not Electric Boat), another furniture supplier quoted prices 30 percent lower than the prices quoted by Electric Boat's sole source supplier.

b. Valve Actuators

The Team Report cites Electric Boat justifications for selection of Sargent Industries on the basis of their technically superior design, proven performance, and more reliable delivery. The report concludes:

"Electric Boat Division is aware of several sources interested in becoming qualified suppliers but there are the ever present constraints of time, quality and funding in the development of additional sources. Nevertheless, such constraints always exist; and unless action is pushed to obtain another source, one will never be obtained, and the sole source situation will be with us forever."

NAVSHIPS 08 Comment

In defending Electric Boat's repetitive sole source procurement of valve actuators from Sargent Industries, the Navy Review Team does not bring out several relevant facts:

1. Some of the items Electric Boat procured sole source from Sargent were formerly procured sole source from another firm which still manufactures these items.

2. NAVSHIPS 08 was informed that several employees of Electric Boat's valve actuator design group left Electric Boat in 1968 and went to work for Sargent Industries.

3. Electric Boat included in its sole source bid packages items for which competition could be obtained.

4. In one procurement, another firm submitted a bid to supply valve actuators. Sargent subsequently dropped its price, but the other firm remained low. Electric Boat proceeded to award to Sargent on the basis that the competitor would not comply with data requirements. However, Electric Boat files indicate that the competitor made it clear that it would comply with contract data requirements.

c. Procurement of Steel as an "add-on"

The team report states:

> "Thus, it is supportable by the purchase order file documentation, even though an urgent situation existed, that Electric Boat Division Procurement Department did obtain competitive quotes for the initial procurement, performed an analysis of such quotes and used the information in placement of the "add-on" orders which were awarded within a reasonable time period of the receipt of competitive quotes.
>
> Nevertheless, EB and the SUPSHIPS must scrupulously refrain from frequent use of the "urgent situation" (sometimes rationalized) to avoid fullest possible use of competition. It could well be concluded that the 13 plate buy in September, two months after the modest 6 plate buy, and for a separate, fourth shipset, was not so urgent as to preclude a competitive procurement."

NAVSHIPS 08 Comment

With regard to Electric Boat's procurement of steel, NAVSHIPS 08 agrees with the statement in the Navy Review Team Report. "It could well be concluded that the 13 plate buy in September, two months after the modest 6 plate buy, and for a separate, fourth shipset, was not so urgent as to preclude a competitive procurement." Obviously, the use of sole source procurement in situations where competition can be obtained results in higher than necessary prices to the Government.

NAVSHIPS 08 Finding - 3

1. NAVSHIPS 08 13 September 1969 Report

"Electric Boat is not making effective use of the Truth-in-Negotiations Act to obtain the lowest possible prices for the Government."

2. Contractor Procurement System Review Report (CPSR):

"Price and Cost Analysis Methods

Review of purchase order files reveals that the contractor is definitely weak in the area of price and cost analysis. There are no formally established pricing histories for repetitive buy type items, nor have data banks been established for cost or pricing data for use in future procurements. Furthermore, no evidence was found in the purchase order files, for 15 cases over $100,000 each, of the contractor making effective use of vendor furnished data in the analysis of vendor proposals.

Weaknessess in the cost/price analysis operations, coupled with a high percentage (in excess of 60%) of non-competitive procurements makes questionable the effectiveness of the contractor's purchasing operations to adequately protect the Government's interests."

3. Navy Department Review Team Report

"Results of the October 1969 CPSR and this current review indicate concurrence with the generalized finding."

However, the Team Report goes on to discuss at length the examples cited in the NAVSHIPS 08 Report involving the procurement of steel flasks and procurement of main sea water pumps. The Team report concludes:

"United States Steel refused to furnish cost or pricing data to Electric Boat Division but did furnish the data to the Administrative Contracting Office SUPSHIP Groton. Electric Boat Division contacted the Defense Contract Audit Agency (DCAA) requesting their assistance in obtaining cost and pricing data and having it forwarded to SUPSHIPS Groton."

* * *

"The files available in SUPSHIP Groton and the Electric Boat Division Procurement Department also disclose that prior to granting consent to placement of this purchase order the Administrative Contracting Officer, SUPSHIP Groton used all of the tools and information available to him in determining the reasonableness of the proposed price."

* * *

". . .it appears as though the [NAVSHIPS 08] statement with respect to the main sea water pump is not factually correct."

4. NAVSHIPS 08 Comment

a. Procurement of Steel Flasks The Navy Department Review Team Report concludes that this procurement was handled properly by SUPSHIPS and by Electric Boat. It does not mention the fact that the cost breakdown showed a 20 percent profit which is higher than can be justified under the DOD profit guidelines, and that this issue was never raised with the steel supplier by SUPSHIPS or by Electric Boat.

b. Procurement of Main Sea Water Pumps The Team makes it appear that Electric Boat, on its own initiative, obtained cost and pricing data and negotiated a lower price for these pumps. The facts are that during April and May of 1968 NAVSHIPS 08 and NAVSHIPS Division of Contracts personnel advised Electric Boat that the government would not consent to the placement of a subcontract for main sea water pumps until cost and pricing data had been obtained and used to negotiate the lowest possible price. This fact was documented in Electric Boat's files which were available to the Review Team. It was at NAVSHIPS insistence that the cost and pricing data were finally obtained. This action resulted in a negotiated reduction of 18% in the proposed price from $216,000 to $176,800 which still provided the supplier a 20 percent profit in addition to a provision for substantial additional contingencies which NAVSHIPS considered unwarranted.

The CPSR Report described Electric Boat's normal practice in such cases. It said:

> "(3) Lack of Effective Use of Cost or Pricing Data
> In the 15 cases cited above, no evidence was found in the purchase order files of effective use of the data to analyze a vendor's proposal. . .Discussion with personnel. . . failed to show that any use was being made of data obtained under the Truth-in-Negotiations Act."

* * *

> "Where [Government] audits are made. . . it is Defense Contract Audit Agency policy to mark the audit reports 'For Official Use Only' and to respect vendor requests that particular information not be disclosed to the prime contractor. As a result, little information of value obtained through the audit finds its way back to the prime contractor for use in price negotiation."

* * *

> "In those cases in which information from the assist audit is not made available to Electric Boat, the audit request is fruitless and compliance with Public Law 87-653 is a sham."

NAVSHIPS 08 review of this matter does show one inaccuracy in its September 1969 report. The report states:

> . . ."For example, Electric Boat submitted a recommendation to the Naval Ship Systems Command (NAVSHIPS) to buy main sea water pumps from a sole-source supplier at $216,000 without obtaining cost and pricing data. On the recommendation of Naval Reactors, the NAVSHIPS Contracting Officer rejected this proposal and requested that cost and pricing data be obtained from the supplier and a revised procurement recommendation be submitted based on the reasonableness of the vendor's costs. . ."

The initial recommendation from Electric Boat was for $195,000 not $216,000; subsequent changes in scope increased the supplier's price to $218,000, which was further revised to $216,332.

NAVSHIPS 08 Finding - 4

1. NAVSHIPS 08 13 September 1969 Report

> "Insufficient effort is being expended to reduce the cost of supplies and materials charged to Government contracts."

2. Navy Department Review Team Report

The Team does not comment on the basic issue. Comments are only made on the examples NAVSHIPS 08 cited with regard to Electric Boat procurement of repair parts, use of GSA supplies, and procurement of chemicals. These are discussed below:

a. Repair Parts:

NAVSHIPS 08 Report:

> "Electric Boat generally procures repair parts through the original equipment supplier without first checking whether they could be procurred more economically by soliciting competitive bids from other suppliers. Procurement files indicate Electric Boat placed spare part procurements of $208,440 for common valve actuator parts, $27,000 for shaft seal spare parts, $17,030 for furniture spare fixtures, and numerous other spare part orders with the original equipment supplier with no justification indicated as to the need to procure these spare parts on a sole source basis.
>
> ". . .prior experience at another prime contractor activity was that many repair parts can be bought competitively at substantially lower prices than can be obtained from the equipment supplier. In many cases, repair parts could be bought competitively for about half of what an equipment supplier would charge for the same part."

Navy Department Review Team Report

The Team Report describes the procedure whereby the Electric Boat Engineering Department personnel specify which items are to be secured proprietarily from original equipment manufacturers and which are standard items. The Team Report concludes that Electric Boat does segregate by records those items that are of a proprietary nature and are to be purchased from the original vendor and those items which can be supplied from other sources.

NAVSHIPS 08 Comment

The Review Team comments do not speak to the issue. The issue is: Is Electric Boat making a diligent effort to obtain the lowest prices for supplies and materials charged to Government contracts? Does Electric Boat obtain competitive quotes in all cases where it could? The answer as evidenced by the examples cited is no. These examples show that Electric Boat is continuing to procure common items proprietarily from equipment suppliers rather than through competitive quotations.

b. GSA Supplies

NAVSHIPS 08 Report:

"The General Services Administration (GSA) office in the Boston Region stated that Electric Boat, as a predominately Government prime contractor, is authorized to procure supplies through the GSA, thereby taking advantage of quantity and other discounts available to the Government. Last year Electric Boat bought commercially about $2.7 million of general purpose supplies, none of which were procurred through GSA. At another prime contractor location, prices obtained through GSA were substantially, in some cases 50% or more, below the normal commercial market prices."

Navy Department Review Team Report:

"The above quote implies that merely being a predominately Government prime contractor authorizes Electric Boat Division to procure supplies through GSA, and that Electric Boat Division has made the effort to take advantage of this potential cost savings. The complete story is less simple."

* * *

> "It is obvious from the information obtained from Electric Boat Division's files, and review of the ASPR requirements that (i) there are many aspects to utilization of GSA supply sources and pricing other than just being a predominately Government prime contractor, (ii) Electric Boat Division has conducted a study related to the economic impact of utilizing GSA supply sources and pricing under the regulations imposed by the Government, and (iii) Electric Boat Division has requested the Government to furnish copies of the Federal Supply Schedules and General Services Administration Stores Stock Catalogs for future use."

NAVSHIPS 08 Comment

The Review Team conclusion in this matter is not clear. What is clear is that the use of GSA supplies would save money for the Government. The Navy should take steps to see that Electric Boat utilizes the most economic sources of supply.

c. Chemicals:

NAVSHIPS 08 Report

> "Another Naval Reactors representative at Electric Boat found that the price Electric Boat was paying for certain chemicals used extensively in the construction and overhaul of nuclear ships was twice that listed in the Navy Stock Catalog for the identical items."

Navy Department Review Team Report

> "The information obtained from the Electric Boat Division's files reveals that the statement regarding procurement of chemicals, based on hearsay, is addressed to selected items and is not representative of a general condition in the procurement of chemicals (note the study disclosed only a $678.26 difference in total price paid during 1969 for those chemicals that could be compared with Navy catalog prices.)."

NAVSHIPS 08 Comment

The team report devotes eight pages to the historical background of chemical procurements. The team's comment--obviously written by the contractor--deals mainly with the contractor's difficulty in securing a copy of Ships Parts Control Center instruction 4440.310 G concerning ordering of chemicals and various other requirements for their use in nuclear reactor plants. None of the comments seem relevant to the issue of whether Electric Boat is making sufficient effort to obtain supplies and materials for government contracts at the lowest possible cost. The specific example is discussed in detail but not the issue.

NAVSHIPS 08 considers that the above examples and others cited in this report clearly show the need for greater effort by the contractor to reduce the cost of supplies and materials charged to government contracts at Electric Boat.

NAVSHIPS 08 Finding - 5

1. NAVSHIPS 08 13 September 1969 Report

"'Competitive' procurements are not handled properly. As a result, there is no assurance that all qualified firms have an equal opportunity in the bidding process or that reasonable prices are being obtained."

2. Navy Department Review Team Report

"Results of the October 1969 CPSR indicate general concurrence with the above statement. Recommendation No. 10 of the CPSR report states that 'That for the awards where competition is obtainable the Electric Boat Division should make the awards as a result of a controlled bid procedure.'"

3. NAVSHIPS 08 Comments

None required.

NAVSHIPS 08 Finding - 6

1. NAVSHIPS 08 13 September 1969 Report

> "The lax procedures and practices employed in the procurement of equipment and material for government contracts are in sharp contrast with the close attention paid by Electric Boat and General Dynamics Management in procurements involving corporate funds."

2. Navy Department Review Team Report

> "Based on the findings of the CPSR and this follow-up review there is insufficient finding of fact to support the statement that the contractor does not give comparable attention to procurements involving Government funds as he does to those involving Corporate funds of the same magnitude."

3. NAVSHIPS 08 Comments

The NAVSHIPS 08 September 1969 Report points out that procurements involving corporate funds were reviewed and approved at a very high level within the company for procurements as low as $300. Moreover, when corporate funds were involved EB conducted audits and extensive negotiations among all competing bidders to establish the lowest possible price. In contrast, when government funds were involved, corporate management was not involved to a comparable extent. The Review Team eport avoids the main issue with a lengthy discussion of who has authority to approve what within the company.

The Review Team cited an example where Electric Boat sent its own auditors to investigate a supplier's proposal under a government procurement. However, this audit involved an item under NAVSHIPS 08 cognizance and was initiated as a result of NAVSHIPS 08's discussions with Electric Boat management over the company's poor purchasing performance.

For procurement actions where Electric Boat is free of any government supervision under the "Approved Procurement System" or "disengagement policy", similar efforts are not made. The Review Team itself noted that no budgets were set up for cost-type contracts. Yet, tight budgets are set up for corporate-funded procurements. Electric Boat does not fly in a team of corporate auditors to audit a $50,000 government-funded subcontract. Nor do they get eight "no bids" to verify that a sole source procurement is necessary for a government-funded $73,900 purchase order. As shown in the NAVSHIPS 08 Report, they have taken such actions for corporate-funded procurements of the same amount.

It is inconceivable that a group of procurement experts could look into the situation at Electric Boat and conclude that there are insufficient facts to support the statement that the contractor does not give comparable attention to procurements involving government funds as it does to those involving corporate funds of the same magnitude. All one has to do is look at the records.

NAVSHIPS 08 Finding - 7

1. NAVSHIPS 08 13 September 1969 Report

   a. Material Costs

> "Electric Boat's material control system contains serious deficiencies such that the validity of material costs charged to Government contracts cannot be determined."

* * *

> "In summary, Electric Boat has not taken effective action to correct the deficiencies in the material control system even after the Government pointed out the seriousness of this problem. The Government has not taken action to require Electric Boat to provide effective control over material costs."

* * *

> "[The Navy should] withdraw approval of Electric Boat's accounting system until effective controls are established to preclude mischarging of labor and material costs on Government contracts."

2. Navy Department Review Team Report

"The Review Team has found that the above statement and supporting comments present an incomplete portrayal of the contractor's material costing procedures and are not supportable in light of the considerations discussed below."

* * *

"In May 1968, the contractor, in accordance with a request from the Resident Auditor, furnished a status report on the material accounting adjustments. That status report indicated that a detailed analysis had been made on approximately 1000 adjustments and disposition had been made on about 850 of these adjustments.

" In light of the above, the Review Team cannot agree with the statement that Electric Boat had not taken effective action to correct the deficiencies or that the Government did not follow-up promptly to insure that EB's corrective action was adequate.

" The second area pertains to the General Dynamics Corporate Headquarters Audit Report issued in June 1969. This audit pertains to a review of the Cost Accounting Materials Section or more specifically, Code Stock Inventory Activity.

" The Code 08 report states, '...they (Corporate Auditors) found serious quantity and pricing errors in inventory charges.'

> "The Review Team discussed this audit with the Corporate Internal Auditor who performed the review and wrote the report. In a memorandum confirming this discussion, the Corporate Auditor stated that, 'Nowhere in our report did we state that the system contained any 'serious' deficiencies, nor did we consider any 'serious' deficiencies to exist." Accordingly, we are unaware of the basis for the Code 08 statement that, '...they found serious quantity and pricing errors in the inventory charges.' "

* * *

> "While the above comments are based on only a brief review of selected transactions entering into the Inventory Adjustment Account during the first quarter of 1969, it does portray a significantly different condition from that implied by the Code 08 report which labels the $2 million as corrections resulting from deficiencies. To the contrary, the existence of the account and its accounting function is evidence of the contractor's effort to control inventory, related material pricing and costing to contracts rather than the absence of such control."

NAVSHIPS 08 Comments

The NAVSHIPS 08 September 1969 Report concluded that the deficiencies in Electric Boat material control procedures were "serious". The Navy Department Review Team apparently considers the Electric Boat material control deficiencies are not serious. This view conflicts with the opinion of the resident government auditor given in an internal memorandum to the Assistant Regional Manager, DCAA, Boston on 5 May 1969, at the time of the General Dynamics headquarters material audit at Electric Boat. In that memorandum, the auditor said:

> "Although a major system revision for control and accounting of material stores was implemented in October 1968, we have no evidence that the condition disclosed by audit in 1967 has appreciably changed . . . In May 1967, we wrote to the contractor that based on our audit of inventory adjustments, we concluded the material stores practices inadequate for accumulating costs under cost-type and fixed-price incentive contracts. [Emphasis added]. However, this was not included in forward pricing or any other reports to the contracting officers. In September 1967, the contractor replied that he understood DCAA's concern about the system and he would take immediate action to correct the 1966 records. In January 1969, when this was subsequently followed up, the contractor replied that 1966 would be fully corrected by March 1969. Our lack of personnel staff and higher priority work on overhead has precluded more timely follow-up. However, since the system was considered inadequate in May 1967, I believe we have some urgency to review the present systems and inform the contracting officer if we are not satisfied. We are not optimistic about our results as we noted that in the first quarter CY-1969 over $2 million in inventory adjustments were recorded on a $10 million inventory. However, we are moving in the direction of making firm conclusions."

The resident government auditor has not issued a report on the adequacy of Electric Boat's material control system since the above was written. In view of the deficiencies cited in other sections of the Navy Department Review Team Report and the recommendations for changes in the contractor's system (discussed below), it appears obvious that serious material cost control deficiencies have existed for some time and that government corrective action has been inadequate.

3. Navy Department Review Team Report

> "The contractor's systems for receiving, handling, storing, and issuing materials is considered to be adequate in all respects for the purpose of supporting the yard's production effort. However, the physical separation of warehouse facilities and the poor maintenance condition of some of these facilities must be a significant factor in the overall cost of the Materials Department."
>
> * * *
>
> "Extensive use is made of computer based systems to control all materials from the time procurements are initiated or shop manufacture is authorized until the time the material is issued to Production Control. These computer systems enable material managers to maintain excellent control and accountability and to relate material support directly to production needs."

NAVSHIPS 08 Comments

The team's statements concerning the "excellent control and accountability" of Electric Boat's material cost control system seem inconsistent with the following statement on page XI-14 of their report.

> "The actual quantities of material on hand under Material Management control is known at all time, but lacking line item prices, the computer run does not show the total dollar value of material in stores by group, weight account, hull or even by total stores account. Similarly, the dollar value of materials issued to Production Control is not known for those materials which are awaiting manufacture or when manufactured are awaiting installation in a ship. Also, the dollar value of materials actually installed in each ship is not known. All of these dollar values are lumped together as 'work-in-progress' (WIP) and are included in the WIP as a running cumulative figure by weight account for each hull. This is considered to be a major deficiency in the contractor's system for controlling the cost of materials." [Emphasis added]

As a result of these and other shortcomings, the review team found that Electric Boat management did not have the following information readily available "to facilitate effective cost control":

a. The actual cost of residual manufactured materials resulting from either contract changes or poor planning.

b. The actual value of material diversions from one contract to another.

c. The actual cost of damaged materials or shop re-work.

d. An immediate tabulation by dollar value of any loss by destruction or fire.

e. The actual realized loss or gain by sale of materials either as surplus or as new items.

f. The actual value being purged from stock as obsolete.

The team also found that there is no control system to ensure that turned-in reusable excess material is being credited to the contract to which it was originally charged. Thus, the team's own findings would appear to support the finding that there are serious deficiencies in Electric Boat material control system.

NAVSHIPS 08 Finding - 8

1. NAVSHIPS 08 13 September 1969 Report

"Through questionable material charging practices, Electric Boat is charging the government for material that remains in inventory and for material that Electric Boat itself has not paid for."

* * *

"[The Navy should] review progress payment procedures so that General Dynamics no longer gets interest-free use of Government funds."

2. Navy Department Review Team Report

"This finding is in reference to the Electric Boat Division's procedures for allocating or distributing coded stock inventory among its major Navy contracts for the purpose of supporting requests for progress payments on each of these contracts.". . .

"The progress payments here however, are based not on 'costs paid,' as implied by the finding. For shipbuilders they are based upon the physical progress achieved. In the materials category progress is represented by the fact that ship construction materials are on hand. The dollar amount of this physical progress is considered to be equal to the value or cost of the materials concerned, and the Government obtains a lien on the materials to the extent of progress payments made."

NAVSHIPS 08 Comment

The team comment is double-talk. What it says is that for the purpose of progress payments, materials costs are "progress".

3. Navy Department Review Team Report

"EB carries in inventory approximately $12-13 million worth of materials at all times. This inventory is made up of approximately $8 million of allocated coded stock (pipe fittings, bar stock etc.) and $3 million of open coded stock (low valve wire, cable, nuts, bolts, washers, fastners, etc.) with the remaining portion consisting of various special shop supplies. It seems an entirely appropriate and equitable approach to acknowledge that a portion of this inventory is on hand for the purpose of ship construction and does in fact represent physical progress. . . ."

* * *

"The ASPR B-303(e) provides means whereby the Government can properly finance commingled inventory allocated to Government contracts provided it is in the best interest of the Government to do so. The question then reduces to what is the most efficient and economical manner to finance material purchased in advance of needs for ship construction contracts. First, consider two likely alternatives if the Government were to refuse to make progress payments on materials in inventory which have been placed there to carry out actual Navy Shipbuilding contracts.

"a. The contractor could purchase all materials as direct materials..."

"b. Electric Boat Division could finance its own inventory with corporate funds. The cost to EB to finance a $10 million inventory would be at least $1 million a year ($10 million at 10% interest per annum). Thus this additional cost of approximately $1 million would be reflected in its shipbuilding contracts through overhead. The Government on the other hand could finance that same inventory at a cost (to the Treasury) of approximately $500,000 a year ($10 million @ 5% annum) but reflect no additional cost to the Navy."

"If these or any other alternative means for maintaining an advance materials inventory are not as economical as Government financing (when proper and appropriate for Government contracts only), then it would appear to be in the best interests of the Government to encourage the contractor to utilize an allocated materials inventory system financed by Government funds (the cheapest money on the market)."

* * *

"It is the recommendation of the Review Team, based in part on the discussion above that the Navy policy on shipbuilder progress payments continue to be 'progress payments for physical progress' (with a limitation, as now used, of 105% of actual costs incurred). Any action by the government to discourage the shipbuilder's early obtaininc and having ready at hand, materials required for construction could be expected to lead only to construction delays and ultimate increased building costs."

NAVSHIPS 08 Comment

ASPR B-303 discusses the records required for control of Government property in the possession of contractors--it does not provide for government financing of contractor inventories. Moreover, ASPR B-303 (e) (ii) and (iii) state:

"(ii) Authorization. The Head of the Procuring Activity responsible for contract administration at the contractor's plant involved or his designee may authorize a contractor who is performing or will perform

> more than one Government contract to use the multicontract cost and material control system in accordance with this paragraph. The property administrator will, for each system authorized, approve detailed operating procedures as are necessary for that particular system.
>
> (iii) Criteria. A multicontract cost and material control system may be authorized if:
>
> a. the contractor demonstrates that savings or improved operations will result from adoption of the system or that it will otherwise be in the interest of the Government;
>
> b. the contractor's accounting system is adequate to satisfy the requirements set out in B-312; and
>
> c. the system is applied to existing Government contracts only and excludes materials acquired or costs incurred for non-Government work or in anticipation of future Government work."

Thus even assuming the Government were willing to allow Electric Boat to obtain progress payments on its inventories, it does not appear that the Government determination required by ASPR B-303 (e) has been made, nor that Electric Boat's accounting for materials is adequate to comply with the conditions cited in ASPR B-312.

The Resident Government auditor described questionable aspects of Electric Boat practices in a memorandum dated 5 May 1969 to the Boston Regional Office, DCAA. He said:

> "The General Dynamics Corporation, Electric Boat Division (Contractor) has claimed and obtained reimbursement for the costs of material purchased in quantities which are not supported by its recorded material requirements for the specific contracts to which the costs were charged. Determination of the extent of these practices and of the reasonableness of significant other material costs estimated at $80 million for period 1966 through March 31, 1969, is hampered by material control and accounting procedures which are unnecessarily burdensome and complex."
>
> "The material costs charged to cost-type contracts represents either (1) an arbitrary allocation of material inventory at month-end, thus obviating the necessity for contractor inventory financing, or (2) quantities which have been delivered but not invoiced by the suppliers, thus permitting the contractor to obtain reimbursement from the

Government prior to making payments to its suppliers. In the latter situation, the approval of more frequent than monthly billings is tantamount to advanced fundings . . . Under the contractor's system of billing materials on evidence of delivery, the contractor is reimbursed within four days and it appears that even with monthly billings this is quicker than payments to suppliers."

In a letter to Electric Boat dated 31 December 1969 (4 months after the NAVSHIPS 08 Report) the Resident Auditor stated:

"3. Monthly Allocations of Inventories

A. ASPR B-303(e) permits the allocation of comingled inventories subject to the approval of the Administrative Contracting Officer. This office is not aware of such an approval and recommends that the ACO be requested to approve the system. If the ACO asks this office for an opinion prior to approving or disapproving the system, this office would be reluctant to recommend approval of the system. Our position is based on the deficiencies set forth in 3B through 3E below.

B. The allocation of indirect materials to burden centers on a monthly basis is unnecessary since indirect costs are recovered on the basis of provisional rates throughout the year. We recommend that this practice be discontinued.

C. The allocation of unassigned allocated stocks is based on a 1966 analysis which has been destroyed. We recommend that a current analysis be performed and periodically reviewed so that the allocation of unassigned allocated stock will be based on current experience.

D. The allocation of the total amount of open stock inventory to contracts gives no consideration for withdrawals for miscellaneous industrial sales, commercial contracts, and burden center costs. We recommend that the procedure for allocating open stock inventory be revised to consider the above omissions.

E. In both the allocated and open stock inventory allocations, there were a number of errors. Errors noted consisted of transpositions, omissions and allocations to contracts under which the vessels constructed had already been delivered."

The Navy Department Review Team did not concern itself with the issue of whether Electric Boat is properly entitled to claim inventory costs as "progress" for the purpose of obtaining progress payments, nor with the questionable aspects of Electric Boat practices such as whether or not Electric Boat's procedures for allocating its inventories to Government contracts each month are proper and in accordance with Government requirements. Nor did it attempt to ascertain how much "float" General Dynamics enjoys under its shipbuilding contracts at Electric Boat as a result of the Government paying Electric Boat for supplies and materials before Electric Boat pays its suppliers; or as a result of the special expedited billing and payment procedures Electric Boat has arranged. The Review Team apparently considers it entirely proper to have the Government borrow money to give to General Dynamics before General Dynamics spends its own money--and to finance General Dynamics inventories--simply because the Government pays a lower rate of interst. These conclusions are at odds with the general policies expressed in the Armed Services Procurement Regulation

differ from the policies applicable to fixed price supply contracts which limit progress payments to 80% of costs incurred. The Team Report does not point out that in accordance with its recommendation Electric Boat would have almost no investment in inventory and thus no incentive to control inventory costs. In fact higher inventory might actually improve the cash flow enjoyed by General Dynamics on Navy shipbuilding contracts.

NAVSHIPS 08 again recommends the Navy revise its progress payment procedures so that General Dynamics no longer gets interest-free use of Government funds.

NAVSHIPS 08 Finding - 9

1. NAVSHIPS 08 13 September 1969 Report

   a. Labor Costs

   > "Under the present labor charging system supervisors have a strong incentive to charge labor costs to the labor budget account that can best absorb the cost and not necessarily to the budget account for the work actually performed."

2. Navy Department Review Team Report -

> ". . . That it is possible for a foreman to charge to the wrong account in some instances is certainly correct, based upon the Team's review, and that matter is discussed under the next finding. The concern here is with the contention that the labor charging 'system' creates a 'strong incentive' for foremen to mischarge. On this precise point, the Team disagrees with finding quoted above. On the basic principle that safeguards should exist against mischarging, the Team agrees fully."
>
> * * *
>
> "In summary, the Review Team sought evidence supporting, but was not convinced of, the contention that EB foremen have a strong incentive to mischarge their labor costs in order to stay within all their budgets. However, the possibility of mischarging of labor costs still exists, for a variety of reasons including those mentioned above, and steps to control such mischarging are discussed under the next finding."

NAVSHIPS 08 Comment

The following excerpts from the minutes of an Electric Boat meeting in February 1969 indicate that company personnel are very much aware of the tie in between labor budgets and profitability:

> "(Name) Budget Control, presented a stimulating picture of the BUDGET LEDGER function in the Budget Control Department. Highlights of (Name) presentation were:
>
> 1. The Budget Ledger is really an up-to-date official statement of the amount of REVENUE that the Government is expected to pay Electric Boat for any given contract . . .

3. In order for the company to make a PROFIT on any contract, the ACTUAL returned COSTS must be BELOW or under the COST levels pegged in the BUDGET REVENUE LEDGER. . .

5. The HOURS locked into the Contract Budget Ledger are furnished to (Name), Manager of Direct Labor Control. (Name), in issuing DIRECT LABOR BUDGETS to the Shipyard, is, therefore, always cognizant of the PROFIT and LOSS impact of the budgets he issues. As the ACTUAL incurred Direct Labor Hours are returned against the B/M and Groups, (Name) is in a position to recommend remedial actions. . . "

The pressure on a supervisor to "charge to the budget" is illustrated by the following statement which was printed on a "Budgeted Man Hour Allocation" form given to supervisors:

> "NOTE: Man hours should be kept within this budget. If you have any questions call the following telephone number 3795." (The telephone number is for "Direct Labor Control".)

The above, plus a requirement that supervisors must review variances from budget with their general foreman, would appear to give supervisors a strong incentive to charge to their budget level, regardless of actual costs.

NAVSHIPS 08 Finding - 10

1. NAVSHIPS 08 13 September 1969 Report

> "A comprehensive review of Electric Boat's labor charging practices has not been conducted. However, there are indications that labor costs are being mischarged. There are no effective controls to preclude such mischarging."

2. Navy Department Review Team Report

> "Review of EB's labor charging procedures indicated to the Review Team that it is possible for shipyard foremen to mischarge incurred hours. This possibility exists in every industrial organization. Safeguards against it should exist. The Review Team therefore focused its attention on what procedures presently exist at EB to minimize mischarging and to provide management with an indicator of the level of confidence which it may have in its cost charging."

The Review Team then describes in detail the deterrents to mischarging of labor costs at Electric Boat. However, it concedes that possibilities exist for mischarging and recommends that the company should institute a meaningful floor check program. The Report states:

> "Discussions with DCAA personnel disclosed that a recent floor check indicated a 32 percent error rate, which was extrapolated into a potential mischarging rate of 20 percent (on 2700 employees) where time was charged erroneously on the day of the floor check. Prior audits also detected errors, but the number of errors were not considered significant. The results of their latest review, however, indicated a substantial deterioration in the contractor's internal controls.
>
> " Summary of discrepancies found:
>
> 1. There are no written labor checking procedures to ensure the adequacy and consistency of review from perior to period.
>
> 2. There is no advance schedule of areas to be labor checked to ensure uniform coverage.
>
> 3. Overhead employees are seldom checked, employees working on ships are never checked, and there is no evidence that employees working on night shift, overtime, or employees on leave are ever checked.
>
> 4. Charges below the contract level are not verified. Therefore the accuracy of labor charges to weight accounts and tasks is not determined.
>
> 5. A statistically-valid method is not being used to select an employee to be checked within a test area which will result in each employee

within the area having an equal chance of being selected.

6. Because of the insufficiency of EB's labor check program, DCAA has had to schedule additional audits in this area.

Based on the above discrepancies, EB's labor check program cannot adequately provide management with an index of labor accuracy."

NAVSHIPS 08 Comment

DCAA report 221-99-1-0011 dated 7 August 1970 comments further on this problem. It states:

> "This report summarizes the results of reviews of labor distribution and related timekeeping practices of the Electric Boat Division (EB), Groton, Connecticut, during the period January - June 1970. The deficiencies noted herein are considered to be of major concern and are summarized for the information of the Government representatives presently sharing a responsibility in the management of Government funds being expended at EB." [Emphasis added]

* * *

> "The contractor's established procedures governing labor charging should have produced reasonably accurate accounting for labor time by contract and work assignment. However, we noted a lack of complete adherence to the prescribed methods by various departments which contributed to an observed 10 percent error rate in recording of employee time to the proper contract. A continual error rate of 10 percent is unacceptable as it generates inaccurate labor costing and billings under cost-type contracts and negates the value of incurred costs used for pricing purposes. In late July, the contractor revised its written procedures relative to labor time recording. The effectiveness of this revision will be evaluated in future labor checks." [Emphasis added]

* * *

> "The prescribed labor accounting practices and procedures required strengthening. Also needed were improved and reliable methods of monitoring the system to assure that accurate labor costs were generated for billing the Government under cost-type contracts and for developing reliable historical data for use in pricing contract work. Lack of internal reviews in this area of operation by EB permitted the weaknesses to go undetected and accordingly, uncorrected."

NAVSHIPS 08 Findings - 11 and 12

1. NAVSHIPS 08 13 September 1969 Report

"a. Under the present system, there is no way to insure that the government is not being overcharged in the adjudication of changes or in the settlement of claims.

b. Present procedures for handling claims against the Government for changed work seem to be heavily weighted in favor of the contractor. [The Navy should] establish principles, procedures, and the means to place the Government on an equal footing with the contractor in settling change orders and claims."

2. Navy Department Review Team Report

"It is the conclusion of the review team that the establishment of the Change Control Department in Electric Boat along with the formation of a Proposal Evaluation Division of the SUPSHIP organization has enhanced immeasurably the ability of the SUPSHIP to cope with the substantial 'change' material. Recommendations to improve the system now have been registered.

* * *

"As addressed in CHAPTER XIII of the Report, substantial improvement has been registered by both Electric Boat and the SUPSHIPS in their organization and procedures for handling CHANGES and claims. Further improvements can be made by action on the recommendations cited."

* * *

"Recommendation: That NAVSHIPS investigate the feasibility of authorizing SUPSHIPS to definitize letter contracts for overhaul and conversion and that SUPSHIPS authority be increased to allow implementation of the disputes procedure when the situation warrants that action and to issue Contracting Officer decisions where appropriate."

3. NAVSHIPS 08 Comment

The fact remains that Electric Boat has not been required to account separately for the cost of changed work so that there is no way to determine whether or not the government is being overcharged on claim settlements.

Under current procedures the Navy places great reliance on Electric Boat's price estimating system to ensure that the government does not pay more than it should on claims, change orders, and other proposals. However, in a report dated July 10, 1970, the resident government auditor pointed out a number of deficiencies in the company's estimating system. Citing a substantial dollar volume of contractor overestimates, the auditor concluded that:

> ". . . the contractor's bidding procedures were not considered adequate with respect to government contract proposals."

The above emphasizes the need to keep accurate records of the actual costs of changed work.

NAVSHIPS 08 Finding - 13

1. NAVSHIPS 08 13 September 1969 Report

> "Government representatives place undue reliance on Electric Boat's procurement system to obtain reasonable prices for the Government."
>
> * * *
>
> "Under the terms of Navy cost-type and incentive contracts with Electric Boat, the Government has the right to review and approve major subcontracts (generally those over $25,000 in value) prior to placement to determine if pricing is reasonable. However, the Supervisor of Shipbuilding has waived this right [based on a NAVSHIPS Procurement System Review Team recommendation of June 1968.]"

2. Navy Department Review Team Report

> "During October 1968 the SUPSHIP, Groton approved Electric Boat Division's procurement system for a period of one year. . . ."
>
> "During the early part of calendar 1969, certain conditions unsatisfactory to the SUPSHIP Groton caused that office to request NAVSHIPS' assistance in conducting a contractor purchasing system review (CPSR). Further, the SUPSHIP deliberately permitted approval of the Electric Boat Division's procurement system to lapse as of 1 October 1969 until the planned CPSR could be conducted and Electric Boat procurement system reevaluated. The overall recommendation of the CPSR, conducted through October 1969, was to withhold approval of the Electric Boat Division's procurement system."

3. NAVSHIPS 08 Comments

The Review Team Report implies that SUPSHIPS uncovered deficiencies in contractors' procurement practices as a result of its own surveillance of the contractors' operations, withdrew government approval of the contractors' procurement system, and initiated a Special Contractor Purchasing System Review to identify deficiencies. It reports that corrective action has been initiated and is nearly completed. In other words, SUPSHIPS and others in charge have been doing a fine job. '

It is possible that the SUPSHIPS became concerned in early 1969 as a result of NAVSHIPS 08 reports which indicated serious deficiencies in procurement operations at Electric Boat and Newport News. The first of these reports dates back to November, 1968--about one month after SUPSHIPS commended Electric Boat for its purchasing system, reporting that the system ". . .affords maximum protection of the Government's interests and assures procurement of materials at the lowest price consistent with quality and required delivery schedules." One of the items cited in the NAVSHIPS 08 November 1968 Report involved an Electric Boat procurement dating back to April 1968 when NAVSHIPS 08 first learned that Electric Boat was not complying with the Truth-in-Negotiations Act in its sole source or limited source procurements. As a result of this finding, NAVSHIPS began including and implementing in contracts with Electric Boat and Newport News a clause requiring NAVSHIPS' consent for procurements over $25,000 under NAVSHIPS 08 technical cognizance.

NAVSHIPS 08 Finding - 14

1. NAVSHIPS 08 13 September 1969 Report

> "Although Government business accounts for 98 percent of the work at Electric Boat, Government auditors do not have access to certain Electric Boat financial reports that are essential in determining the reasonableness of charges to Government contracts."

2. Navy Department Review Team Report

The team cites two Defense Contract Audit Agency responses. The first in October 1969 stated that the Defense Contract Audit Agency did have access to all accounting and financial records necessary to the performance of their audit responsibilities. Later the Defense Contract Audit Agency found that it was not getting copies of contractor reports concerning estimates to complete contracts and contract profit forecasts. The Defense Contract Audit Agency stated this problem was subsequently resolved. The review team stated "Electric Boat Division has been cooperative and very responsive to inquires by the review team".

3. NAVSHIPS 08 Comment

This Defense Contract Audit Agency reaction to this issue is typical of the reaction to the issues raised concerning shipyard problems. The NAVSHIPS' 08 Report of September 1969 pointed out that the resident government auditor at Electric Boat did not have access to labor budget reports and other financial records and reports relevant to government contracts. The auditor's response was to claim NAVSHIPS 08 didn't know what he was talking about. He stated:

> "Presently we do have access to all accounting and financial records which we consider necessary to the performance of our audit responsibilities."

But a NAVSHIPS 08 representative found that the auditor was not aware of several other reports EB was preparing at government expense. When the auditor became aware of some of these reports, he wrote the company, in December 1969:

> "Since we have been denied access to certain contractor reports, we cannot report on the accuracy of the estimates to complete. Due to the critical nature of Government funds and because of the deficiencies noted in our review, this office is particularly concerned with the projected cost to complete contracts by element of cost. This information is available only on the 'Contract Profit Forecast Data' report. Access to this report and the 'Quarterly Contract Analysis' report is considered essential for us to conclude that the contractor's financial management system is adequate and responsive to Government procuring agency needs."

Now he again states that:

> "Presently we do not have any access to records problems in the performance of our audit responsibilities."

NAVSHIPS 08 questions whether either the Defense Contract Audit Agency auditor or the Supervisor of Shipbuilding yet has a comprehensive listing of financial information and cost reports that are being prepared by Electric Boat at Government expense. In addition:

a. The review team, elsewhere in their report, noted there is a large volume of detailed historical data and other information that is not being made available to the government to support Electric Boat contract price proposals.

b. In May, 1970, the government auditor asked Electric Boat for information on royalties received for patents developed under government contracts. To date the company has not provided the government auditor this information.

NAVSHIPS 08 Finding - 15

1. NAVSHIPS 08 13 September 1969 Report

> "Government representatives do not review the company's 'Make or Buy' decisions and there are indications that such decisions are not always made with the interests of the Government foremost."

2. Navy Department Review Team Report

> "The NAVSHIPS 08 finding quoted above is supported by a single example of an EB 'Buy' decision which allegedly was not in the best interests of the Government."
>
> * * *
>
> "Of course, other persons faced with the decision in this case might reasonably have reached the opposite result and had the valve overhauling done at EB. But on the basis of the information available to it, the Review Team finds that even if one disagrees with it, the decision to subcontract with Vickers was a reasonable exercise of business judgment, not an abuse of it. Furthermore, since EB performs its submarine overhaul work under CPIF prime contracts and since the Government pays 99 percent of EB's overhead, the total cost approach taken by the Committee (in its consideration of the additional material management and inventory costs of the 'Make' decision) was the approach considered as being the one that would best protect the Government's interests in this case. Thus the NAVSHIPS 08 finding quoted above is not concurred in." [Emphasis added].

3. NAVSHIPS 08 Comment

This is another case where the Review Team agrees with the overall NAVSHIPS 08 conclusion, but disagrees with the example. However, the Review Team comments miss the point of the example. The Make or Buy committee report shows that the Electric Boat decision was based not on the potential saving in total cost, but on the amount of additional fee to Electric Boat. Electric Boat decided that it was not worthwhile to try to save the Government $23,000 when it would only keep $4,000 of the saving as additional fee. Thus, NAVSHIPS 08 recommended that the Government ought also to be reviewing Electric Boat's Make or Buy decisions.

The Review Team comment cited punctuation errors in NAVSHIPS 08 quotation from the Electric Boat Make or Buy committee report. In this respect, the Team was correct.

NAVSHIPS 08 Finding - 16

1. NAVSHIPS 08 13 September 1969 Report

> "The Supervisor of Shipbuilding does not review Electric Boat procurements from other divisions of General Dynamics Corporation. The contractor does not justify the cost of these procurements or indicate whether or not these items are being obtained at less cost than would be possible from other companies."

* * *

> ". . . For example, in March, 1969, Electric Boat placed cost-type procurements for ball valves valued at $2.5 million with the Canadair Division of General Dynamics in Montreal, Canada. No justification for the estimated costs was given and the files indicate that no effort was made to verify the reasonableness of estimated costs for this work. After being questioned about this, the local Government auditor has taken steps to have Canadair costs audited by Canadian Government auditors."

2. Navy Department Review Team Report

> "Ball valves for new construction submarines have historically been 'make' items produced either by Electric Boat Division or General Dynamics subsidiary Canadair, Limited. The transfer of work referred to above for SSN 678-684 was processed in accordance with and met all requirements of Armed Services Procurement Regulation (ASPR) and corporate directives."

3. NAVSHIPS 08 Comments

The Team Report did not address the issue raised by NAVSHIPS 08. It also neglected to address several important facts relating to the example cited by NAVSHIPS 08 in its report:

1. Ball valve procurements through Canadair Division of General Dynamics involve substantial dollar amounts--$2.5 million in 1969. The government has recognized costs reported by Canadair Division without benefit of audit verification.

2. If a prime contract of this size or if a subcontract of this size were awarded following normal government procedures, the government would review the pricing and the terms of the procurement.

3. There are indications that the Government is paying more than it should for ball valves from Canadair. The following is quoted from the October 1969 CPSR Report:

> "In two prime contracts recently the Navy has affirmatively required Electric Boat to solicit and accept the results of open competition in the procurement of ball valves. The prime contracts involved are CPFF contracts to procure long leadtime materials for certain submarine overhauls and conversions (N00024-68-C-0203 and N00024-69-C-0325).
>
> "As a result of this requirement in contract 0203, Electric Boat obtained competitive quotations on three different ball valve purchase orders. The low bidder on all three orders was Hydromatics, Inc., and it received the awards. Canadair was second low bidder on the two orders for which it bid. Two other bidders were substantially higher in price overall.
>
> "Although this instance appeared to be a case of competition working to the benefit of both the Navy and Electric Boat, Electric Boat personnel have insisted that Canadair is by far the most reliable manufacturer of ball valves, and that Electric Boat has experienced substantial difficulties in negotiating changes and obtaining delivery as scheduled from other vendors such as Hydromatics. On the purchase orders under the CPFF prime contract described above, however, Electric Boat expediting personnel conceded that Hydromatics was delivering on time."

NAVSHIPS 08 Finding - 17

1. NAVSHIPS 08 13 September 1969 Report

"The Supervisor of Shipbuilding does not adequately review major areas of cost at Electric Boat considering that the government ultimately pays at least 98 percent of these costs."

2. Navy Department Review Team Report

"Under the above finding NAVSHIPS 08 stated that SUPSHIPS had included in approved overhead rates costs of development of an artic submarine tanker amounting to one million dollars, despite the determination by the Defense Contract Audit Agency that these costs are unreasonable."

* * *

"1. Conclusions: SUPSHIPS maintains that Artic Tanker costs have been excluded from the projected overhead rates negotiated between EB and SUPSHIPS. In support of their arguments SUPSHIPS claims the Defense Contract Audit Agency representative Mr. Doyle was present at the negotiations and is aware of this fact. In addition, SUPSHIPS workpapers indicate that the costs were excluded. This was also confirmed by Mr. Fred Acker, Manager of Financial Analysis at EB, who stated that the Artic Tanker costs have been definitely excluded from the negotiated overhead rate package. However, as late as March 1970, the Defense Contract Audit Agency in a Summary History of Audit Results states that, 'while we have taken the position that a $1.5 million bid and proposal cost in overhead is unreasonable in our forward pricing rate, the results of the negotiations do not indicate whether the cost of this bid and proposal was negotiated out or not. The ACO (SUPSHIPS) tells us it was, and the contractor persists as to its allowability. Accordingly, during the review of 1970 bid and proposal costs, we anticipate some problems.'

2. Our review indicated that the Artic Tanker costs have been excluded from the projected overhead rates approved by SUPSHIPS. In addition, it is the Defense Contract Audit Agency's intention to make appropriate adjustments on any payments to EB in the event such costs are included in Government contracts."

3. NAVSHIPS 08 Comments

Again, the Review Team addressed only the example cited rather than the issue raised by NAVSHIPS 08. The Artic Submarine Tanker was only one example to illustrate the general point that the government does not look carefully enough at contractor costs, particularly in the overhead account. NAVSHIPS 08 has looked further into this matter and made it the subject of a separate NAVSHIPS report dated 15 July 1970. That report points out specific examples of inadequate government surveillance of Electric Boat overhead expenses.

NAVSHIPS 08 Finding - 18

1. NAVSHIPS 08 13 September 1969 Report

"A number of former Electric Boat employees are working in the offices of the Supervisor of Shipbuilding and the Government Auditor. This situation is not conducive to proper business relationships between the government and Electric Boat."

2. Navy Department Review Team Report

"As of the period of the cost control review at Electric Boat, the Supervisor of Shipbuilding (SUPSHIPS), Groton had 110 employees out of 332 onboard who were former employees of the Electric Boat Division. At the same time the resident auditor, Defense Contract Audit Agency, Groton had two former EB employees out of 15 auditors and their supporting staff."

* * *

". . . the review team found that the risk was relatively small that any former EB employee might influence government policies significantly. This conclusion is based, in part, upon the fact that all of the SUPSHIPS departments have military officers from outside the local area as department heads, none of whom are former EB employees. It is also based in part on the fact that those former EB employees who have risen to a relatively high position within the SUPSHIP have been employed with the government for many years and held on only ministerial responsibilities at EB."

* * *

". . . the review team considers that a blanket prohibition on the employment of former EB employees by the resident government activities at Groton would be impractical."

3. NAVSHIPS 08 Comments

As stated in NAVSHIPS 08 Memorandum of 19 Feburary 1970:

"I do not agree that it is right to employ former contractor personnel in surveillance of the contractor's operations. I am aware that NAVSHIPS employs former contractor personnel in positions having engineering surveillance responsibilities over the activities where they were formerly employed. There are also a number of cases where former contractor personnel are working in the NAVSHIPS contracts division and where former NAVSHIPS contracting people work for shipbuilders. However, I do not consider such practice to be in the best interests of the Government. It may be that SUPSHIPS has violated no law or regulation in hiring more than 100 former employees of the contractor; it still seems to me a violation of common sense to place these employees in a position where they are expected to critically review the performance of their friends and former colleagues. The Navy must put a stop to this practice, particularly when the position being filled is directly concerned with the negotiation or administration of contract matters."

NAVSHIPS 08 Finding - 19

1. NAVSHIPS 08 13 September 1969 Report

"There are indications of some recent improvement in Government surveillance of Electric Boat. However, the Government must take much stronger action to correct the fundamental deficiencies at Electric Boat."

2. Navy Department Review Team Report

"The purpose of the Review Team's assignment to Electric Boat was to review this contractor's procurement and cost control systems. These systems have been reviewed; they are addressed in the parent report. The Review Team found that the contractor had taken action to implement all of the recommendations of the October 1969 CPSR. Further, he has acted to adopt several additional modifications informally suggested as a result of this review. With continued effort in the procurement area, Electric Boat should be ready for a procurement system certification examination by October 1970.

"Basically the contractor's cost control systems were determined to be sound; however, modification and extention is needed to provide work package control information for industry and change order costing. Several extentions of an excellent materials system are needed to provide dollar value, continued accountability, and improved progressing. Additionally, the review of methods and practices in the production area with view to institute engineered standards should improve efficiency in both work and the associated estimating/budgeting. Systems are a necessary structure of an organization to maintain direction, continuity, and control in the area of data collection/reporting; however, the best systems serve little purpose if they are are not properly monitored, and the data utilized. Especially this is true with cost control systems. Electric Boat has these systems, but they are not being utilized to the extent feasible. The Report speaks to this.

"The SUPSHIPS as the government's on site representative with responsibility to administer the various Electric Boat contracts, has recently moved in several areas of endeavor to improve their surveillance operation; namely, contracts and inspection/QC. It is difficult to alter the philosophy and practices of an engineering orientated organization to those with a manager with hands-off surveillance. In order to accent the importance of and the necessity for SUPSHIPS surveillance of the contractor's procurement and cost control system, it is suggested that pertinent NAVSHIPS instructions in this regard should be issued and the implementation supervised. Some additions to the supervisor's staff may be necessary."

3. NAVSHIPS 08 Comment

The review team report paints a very encouraging picture: there are minor deficiencies at Electric Boat, but these are being quickly corrected by the contractor and by NAVSHIPS. NAVSHIPS 08's conclusion is not encouraging. Some "paper changes" have been made at Electric Boat; but there is little or no real improvement in actual practice. The Navy continues to find poor procurement practices, improper labor and material charges, higher than necessary operating costs, inadequate accounting for costs and inadequate government administration of contracts at Electric Boat. Despite impressive milestones, action plans, and reassuring words, the fact is that little has been done to correct the fundamental deficiencies pointed out in the NAVSHIPS 08 September 1969 report.

Final Comment

Navy Department Review Team Report

"Although NAVSHIPS 08 was invited to assign personnel to participate in this review, it declined to do so. Further, efforts by the review team to discuss the NAVSHIPS 08 findings with NAVSHIPS 08 representatives were unsuccessful."

NAVSHIPS 08 Comment

NAVSHIPS 08's memorandum of 20 February 1970 recommended that experienced specialists investigate Electric Boat to "establish the full facts." While NAVSHIPS 08 did not have personnel available for full time assignment to the team, NAVSHIPS 08 representatives met with the review team director in Washington on 24 March 1970 and pledged full cooperation. It was made clear to the review team director that NAVSHIPS 08 would provide answers to any specific questions or requests for information. It was agreed that these questions would be channeled through the team director to NAVSHIPS 08 for reply. Because of this agreement, team members at Groton making inquiries to local NAVSHIPS 08 representatives at Groton were referred to the team director in accordance with the prearranged procedure. NAVSHIPS 08 received no requests for information or assistance from the team director or his staff.

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20350

17 SEP 1970

MEMORANDUM FOR VICE ADMIRAL RICKOVER

Subj: Procurement Practices and Cost Controls at Electric Boat Division, Groton, Connecticut

Ref: (a) Procurement Practices and Cost Controls at Electric Boat Division, Groton, Connecticut

Reference (a) forwarded your views on the NAVSHIPS Procurement and Cost Control Review of Electric Boat Division. Reference (a) takes no exception to the main body of the Review Report or to the recommendations developed by the Review Team for improving Electric Boat's procurement practices and cost controls.

Reference (a) does object, however, to the Review Team comments on the charges contained in earlier memoranda from your office concerning procurement and cost control practices at Electric Boat. In regard to these issues, two points are noted. First, although you consider that the Review Team dwelled on your earlier memoranda at undue length, the Team was urged to come to grips with all of the matters raised in those memoranda. No thorough review of Electric Boat could have failed to investigate the charges which you had made earlier. Second, I was quite concerned over the implication in your suggestion that one particular portion of the Review Report comments on your earlier memoranda might have been written by the contractor. Those members of my staff who participated in the review have advised me that such comments were both researched and written by the Review Team.

I am forwarding your comments to me to the Chief of Naval Material for appropriate comments, action and incorporation into the improvement program at Electric Boat. My primary concern is to ensure vigorous action to formulate and implement a proper program. To this end, I have directed NAVSHIPS to take the appropriate implementing action and requested the Chief of Naval Material to monitor the progress. This office will remain in close touch with these efforts. I share with you the objective to obtain the maximum defense possible for the U. S. within the fiscal resources made available to us. Your cooperation in achieving this objective is always requested, acknowledged and appreciated.

Frank Sanders
Assistant Secretary of the Navy
(Installations and Logistics)

24 SEP 1970

Copy to:
CNM
COMNAVSHIPS

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

08H-780
13 October 1970

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Lack of Corrective Action on Procurement and Cost Control Deficiencies at Newport News Shipbuilding and Dry Dock Company

Ref: (a) Commander, Naval Ship Systems Command Memo 0763:JF:dsr Ser 334 dated 24 November 1969
(b) Deputy Commander for Nuclear Propulsion Memo to Assistant Secretary of the Navy (Installation & Logistics) Ser 08H-1337 dated 30 April 1969
(c) Deputy Commander for Nuclear Propulsion Memo Ser 08H-6403 dated 23 December 1969

1. This memorandum concerns the Navy's lack of progress in correcting two problem areas at Newport News Shipbuilding and Dry Dock Company:

a. The lack of an effective form of cost control for work on government contracts; and

b. The Navy's failure to require Newport News to comply with the Truth-in-Negotiations Act in its procurement of hull steel for Navy ships.

Reference (a) set up various schedules and milestones designed to correct the deficiencies in cost control and procurement practices at Newport News. These schedules have not been met, and the shipyard has intimated that some of the milestones will be delayed for months. For the most part these problems, which I first reported more than a year ago, still exist at Newport News today.

2. Ineffective Cost Controls. As I first reported in reference (b), there is no way to insure that work performed in the shops and on the waterfront is within cost budgets established by the company's management. About half of the work at the yard is carried on without any form of cost budgeting. The shipyard's own survey in 1968 revealed mischarging of costs.

Government representatives have made several reviews of Newport News' cost control procedures. The resident defense auditor has issued three reports this year recommending that the Newport News budget control and production control systems be integrated to provide reliable cost control. A Navy study is considering the cost control problem in connection with a general review of shipyard cost accounting issues requested by the Assistant Secretary of the Navy for Financial Management. However, the Navy has not reached agreement with Newport News on a schedule for developing and implementing an effective cost control system.

3. Procurement of Steel. Deficiencies in the procurement of hull steel by the Navy and its shipbuilders were first reported by the General Accounting Office in 1965. The GAO criticized the shipyards, including Newport News, for failing to obtain cost and pricing data from suppliers of hull steel, as required by the Truth-in-Negotiations Act. Four years later I found that Newport News still employs the practices criticized by the GAO to avoid the Truth-in-Negotiations Act. As a result, the company is still buying hull steel without obtaining cost and pricing data from its steel suppliers; thus the Navy cannot determine whether the prices paid for hull steel are reasonable or excessive. After I reported these findings in reference (c), the Naval Material Command, on 17 March 1970, suggested that NAVSHIPS prepare a letter refering this matter to the office of the Secretary of Defense and recommending an audit of steel suppliers to assure that prices paid by the Navy's shipbuilders are reasonable. As of October 13, 1970, this audit had not yet been requested. In the meantime, I have seen no indication of any change in shipyard procurements of hull steel.

4. Recommendation. As I pointed out in references (a) and (b), we cannot rely on Newport News to correct these problems. Rather, the Navy will have to take affirmative action. I recommend the following steps:

a. The Navy should meet with Newport News to determine what must be done by the yard, and by the Navy, in order to establish effective controls over labor and material costs. The Navy should establish schedules for corrective action and see to it that all schedules are rigidly followed;

b. The Navy should request the audit of steel suppliers' prices. Until there is evidence that these prices are reasonable, Newport News should be required to obtain cost and pricing data on its steel procurements.

Since Navy representatives at the shipyard are not taking action to correct these two problems, it is apparent to me that the initiative will have to come from NAVSHIPS headquarters.

H. G. Rickover
H. G. RICKOVER

Copy to:
CNM
ASN (I&L)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-786
30 Oct 1970

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Excessive Shipbuilder Profits on Nuclear Submarine Overhaul and Conversion Contracts

Ref: (a) Memorandum for ASN (I&L) from Deputy Commander for Nuclear Propulsion, NAVSHIPS, dated 13 September 1969
(b) Commander, NAVSHIPS letter 0763:JF:dsr, Ser: 2 dated 20 January 1970
(c) NAVSHIPS ltr 022:CMK:epm, 4280, Ser: 19 dated 3 September 1970 (NOTAL)

1. I have sent you several memoranda over the past two years concerning serious deficiencies in shipbuilder procurement and cost control practices under Navy ship design, construction and overhaul contracts at our major private shipyards. I pointed out that these deficiencies are resulting in unnecessary costs to the Government and urged that Government administration of these contracts be improved.

2. One issue I raised in reference (a) was the amount of profit being paid to shipbuilders under sole and selected source contracts for Navy ship construction and repair work. I pointed out:

a. Under present policies, profits on these contracts are negotiated as a percentage of estimated costs. Since higher costs in the long run result in higher profits, the shipbuilder has little or no incentive to keep costs down.

b. The most common measure of profitability is return on investment. However, under present Navy profit policies, a shipbuilder has no incentive to invest capital in order to improve efficiency and thereby reduce costs. If he increases investment and profit stays the same, the return on investment is lowered. If the increased investment results in lowered costs, profit may go down and the return on investment is again lowered. Thus shipbuilders have an overriding incentive to minimize their investment and maintain the highest practicable cost basis for profit.

c. Since 1963 the Navy has substantially increased the rate of profit negotiated in its shipbuilding contracts--from about 7% in 1963 for cost type contracts to about 10% in 1969.

d. With respect to Electric Boat, a 10 percent profit on Navy contracts would result in a return on invested capital of 30 to 35 percent annually. This rate of return is far higher than industry averages shown by Fortune Magazine's surveys of the 500 largest U. S. companies.

I recommended that the Navy revise its policies to make return on investment the primary basis for establishing profit for ship construction and overhaul contracts and to give shipbuilders a positive incentive to reduce their costs.

3. In reference (b) COMNAVSHIPS responded to reference (a) that:

a. Profits on shipbuilding contracts are based on the Weighted Guidelines method of profit calculation set forth in the Armed Services Procurement Regulation. NAVSHIPS did not consider shipbuilding contracts represented a situation requiring an exception to the use of the Weighted Guidelines profit calculations.

b. Electric Boat had not realized the rates of profit allowed by the Navy in its contracts. Actual profits were far lower than negotiated profits. Some contracts resulted in losses.

c. NAVSHIPS considered no action was required on my recommendation regarding profit policies.

4. As was the case with other issues I have raised in memoranda to you, it appears that COMNAVSHIPS simply referred my recommendation to the very same people who were responsible for shipbuilding contracts. As could be expected, their response was that no action was required. The facts, however, do not support the NAVSHIPS position. SSBN submarine overhaul and conversion contracts at Electric Boat and Newport News provide a glaring specific example. Below is a comparison of costs and profits on six recent SSBN overhaul and conversion contracts--three with Electric Boat and three comparable contracts with Newport News:

Negotiated Cost and Profit (Fee)
($ in millions)

	Target Cost	Target Fee	Fee Rate
Electric Boat			
SSBN 617	$29.0	$2.8	9.5%
SSBN 623	27.6	2.6	9.5%
SSBN 627	30.0	2.9	9.5%
TOTAL	$86.6	$8.3	9.5%
Newport News			
SSBN 626	$19.9	$1.8	9.0%
SSBN 624	21.1	1.9	9.0%
SSBN 629	22.2	2.2	10.0%
TOTAL	$63.2	$5.9	9.4%

Actual Cost and Profit (Fee)
($ in millions)

		Cost	Profit(Fee)	Fee Rate
Electric Boat				
SSBN 617		$28.0	$3.0	10.8%
SSBN 623		25.3	3.4	13.2%
SSBN 627		31.0	2.8	9.2%
	TOTAL	$84.3	$9.2	10.9%
Newport News				
SSBN 626		$18.9	$2.5	13.0%
SSBN 624		17.2	3.1	18.2%
SSBN 629		21.9	2.2	10.0%
	TOTAL	$58.0	$7.8	13.4%

5. The above comparison shows:

a. Newport News' cost to perform three SSBN overhauls was about $58 million. For that work Newport News received a fee of $7.8 million. Electric Boat's cost to perform three comparable overhauls was about $84 million--$26 million more than Newport News. For this work, Electric Boat received a fee of $9.2 million. The Navy thus paid $1.4 million more profit-- about 18% more--to the shipyard doing the work at the higher cost.

b. Navy profit policies on these contracts resulted in actual profits for both shipbuilders significantly higher than the 10 percent maximum limitation established by the Armed Services Procurement Regulation for cost-type contracts.

c. In all but one case, these contracts resulted in higher actual profits to the shipbuilder than the negotiated target profit.

6. This comparison raises several questions about the Navy's present procurement and profit policies:

(1) Why are Electric Boat's costs about 45 percent greater than Newport News' for comparable work?

(2) Why does the Navy pay more profit to the more costly shipbuilder?

(3) Why should the Navy be contracting on a basis which permits 10 to 13 percent profit on cost reimbursement type contracts on which the shipbuilders have no risk of financial loss?

7. In awarding these contracts, NAVSHIPS requested and obtained approval from the Chief of Naval Material to exceed the ASPR 10% maximum fee limitation for cost plus incentive fee contracts. Moreover, in reference (c) NAVSHIPS requested a blanket approval to continue negotiating overhaul and conversion contracts which provide for profits higher than prescribed by ASPR. This seems inconsistent with the NAVSHIPS position in reference (b)—that ship construction and overhaul work does not represent an unusual pricing situation requiring an exception to ASPR guidelines. I see no logical, legal, or other reason why the Navy should continue to pay such high fees on negotiated, sole source, cost reimbursement type contracts. I consider these fees excessive.

8. Navy ship construction and overhaul contracts contain many provisions peculiar to the ship construction and overhaul work; these represent exceptions to the general policies which apply to other suppliers of military equipment. Examples are:

a. Special progress payment provisions permitting payments higher than those for fixed price supply contracts.

b. Special provisions limiting shipbuilder liability.

c. Special provisions with respect to guarantee and correction of defects.

d. Special provisions for Government self-insurance.

e. Special provisions eliminating responsibility for design.

These provisions severely limit shipbuilder risk under Navy ship construction and overhaul contracts; they must be taken into account in establishing profits for Navy contracts.

9. From the above, I believe it is clear that Navy profit policies for ship construction and overhaul contracts need immediate and substantial revision. In view of the special considerations pertaining to shipbuilding work, i.e., a high percentage of sole and limited source contracts, widely varying costs of performance, and special contract provisions limiting shipbuilder risk, NAVSHIPS cannot rely on the weighted guidelines method of profit computation to establish proper profit levels on ship construction and overhaul contracts. These special considerations, together with shipbuilder capability, efficiency, and investment must be taken into account in establishing appropriate profit policies for shipbuilding work.

10. The Navy cannot avoid its rightful responsibility to insure that only reasonable profits are made on ship construction and overhaul contracts. In 1951, our major private shipbuilders were all independent companies, having their own managements and devoted chiefly to shipbuilding. At that time Renegotiation provided some protection against excessive profits on ship construction and overhaul work. Today all our major private shipbuilders are divisions or subsidiaries of large conglomerates. Shipbuilder profits are averaged in the parent corporation's overall profit on defense business. This is wrong. The Navy must find out exactly what profits its shipbuilders are making--particularly when 90 to 99 percent of their business is with the Government. I am sure that Congress is under the mistaken impression that the Navy does know what profits its shipbuilders actually make.

11. I believe the Navy should take action to:

a. Establish policies to insure that negotiated profits for ship construction and overhaul contracts are reasonable in light of the shipbuilder's capability, efficiency, and investment, and are not based principally on his costs.

b. Require shipbuilders to provide annual reports of costs and profit from Navy ship construction and overhaul work along with all necessary data required to measure shipbuilder investment and efficiency.

12. In addition to the above, which can be done at once, I recommend that the Navy initiate action with Congress to amend the Renegotiation Act so that ship construction and overhaul contracts will be renegotiated on an individual basis, rather than in the aggregate with other defense contracts as the Act presently provides.

13. By taking these actions we would be doing the job we are paid to do--seeing to it that the taxpayers' dollar is spent more prudently than is now the case.

14. I urge that you give this matter your personal attention and direction. Only in this way will action be taken in a timely manner. Otherwise we will have to go through the usual delaying actions and indignant excuses of those responsible for the sorry situation.

H. G. Rickover
H. G. RICKOVER

Copy to:
CNM
COMNAVSHIPS
SHIPS 02

COPY

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20350

20 Nov 1970

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Profits on Navy Business Earned by the Navy's Major Private Shipbuilders

Ref: (a) NAVSHIPS 08 memo of 30 Oct 1970 to ASN(I&L), copy to CNM and others; Subj: Excessive Shipbuilder Profits on Nuclear Submarine Overhaul and Conversion Contracts

The main issue raised in reference (a), the desirability of evaluating contractor profit as a percentage return on invested capital, is not new to the Navy or the Department of Defense. At least as far back as 1967 this issue was examined by the Logistics Management Institute, and various DOD committees have wrestled with the matter since then. The main problem seems to be to develop a realistic but practicable and easily administered method of determining the amount of a contractor's private capital devoted to any particular contract. I am aware that an Armed Services Procurement Regulation Subcommittee is preparing to test certain approaches to this problem.

Although such efforts at the DOD level have not been completed, reference (a) indicates to me that the Navy must take its own actions in areas, such as shipbuilding, where it has a unique interest. Listed below are three actions which I would like to see taken immediately.

1. NAVSHIPS should forward to this Office its comments on reference (a), particularly on the allegations concerning the relative costs at Electric Boat Division and Newport News Shipbuilding for doing comparable work (pages 2 - 3 of reference (a)).

2. I would like to see, for Electric Boat Division, Newport News Shipbuilding, and Ingalls Shipbuilding, a recent summary statement of income on each yard's overall Navy business (showing net sales, cost of sales, gross profit, other income or expense, and profit before income taxes). I understand that NAVSHIPS has already taken some steps toward obtaining such data.

3. I believe that it is feasible to have NAVSHIPS select a prospective ship construction or overhaul award for experimental application of the concept of profit as a return on private capital in the pre-negotiation determination of profit objectives and in the negotiation of profit with the contractor. Sufficient study of the matter would seem to have been done to date to permit such an experiment. The return-on-investment approach should be

done in addition to the present Weighted Guidelines method of profit analysis. With the negotiator's profit objective being the resultant of the two analyses. I would like to receive NAVSHIPS' nomination of a prospective award for such an experiment, along with a schedule for placing that award. Such NAVSHIPS action need not be conditioned upon resolution of DOD policy in this area. However, the provisions of ASPR 1-108(a)(iv) should be followed by providing the ASPR Committee with advance notice of NAVSHIPS' desired application, on a test case basis, of the return on invested capital concept.

I welcome any comments or suggestions which you might have on the above program and would appreciate hearing from NAVSHIPS within thirty days.

FRANK SANDERS
Assistant Secretary of the Navy
(Installations and Logistics)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H - 799

2 [illegible]

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (FINANCIAL MANAGEMENT)

Subj: Contractor Cost Performance Measurement for Commercial Shipbuilders

Ref: (a) Report of the Special Review Group of Newport News Shipbuilding and Dry Dock Company, dtd 11 September 1970
(b) ASN(FM) Memorandum for the VCNO dtd 17 November 1970, Subj: Contractor Cost Performance Measurement for Commercial Shipbuilders

1. Reference (a) is the report of the Special Review Group you established at the request of the Vice Chief of Naval Operations to determine the causes and the extent of cost accounting problems at commercial shipyards as described in various reports I have submitted over the past two years. Reference (b) requested my comments on this report.

2. My comments are:

a. The report confirms that the Newport News cost control system is not adequate to control costs under Navy shipbuilding contracts. No doubt a similar problem exists at other shipyards.

b. In any report of this scope, there are always minor points with which one could take issue. But the overall conclusion of the Special Review Group is correct: there is no effective cost control at Newport News, and the Navy must take steps to establish such control at Newport News and at all shipyards.

c. The report recommends that Department of Defense Instruction 7000.2 be implemented for shipbuilding contracts. While this instruction provides a reasonable basis for developing uniform cost control criteria, some modifications may be needed to make the cost control requirements compatible with shipyard production processes.

d. I believe that NAVCOMPT, as the Navy's financial management expert, should and must take the initiative in developing and implementing effective cost controls. The organizations supposedly responsible for cost control have been unable to recognize or cope with the problem, despite the fact that the situation has been brought to their notice. The following, from my memo of 26 August 1970 to the Assistant Secretary of the Navy (Installations and Logistics) regarding the NAVMAT review team's report on procurement and cost control deficiencies, is apropos:

> "I see no hope of ever improving administration of our shipbuilding contracts through existing organizations. Therefore, I recommend that you take action with the Chief of Naval Material to institute whatever new organizational relationships are necessary to obtain proper administration of these contracts.
>
> "The Navy must make a choice: it can take firm steps now to demand and obtain acceptable performance by its contractors and to provide for proper administration of our shipbuilding contracts, or it can allow these problems to drag on until the General Accounting Office or Congress requires the Navy to take action. I am sure you understand the importance to the Navy of setting its own house in order without being forced to do so by an outside agency or by Congress.
>
> "I am more than disturbed at the constant effort by the very people who have been responsible for the faults I discovered to talk them away. It is discouraging that so many officials in the field and at headquarters will not face up to facts; apparently they will have to be hit by a sledgehammer. At the slightest sign of 'improvement' they become euphoric and say: 'See, it wasn't that bad at all, and even if it was bad, the company has now reformed itself.' They then go about 'business as usual', which means going back to doing little or nothing about the basic issues.
>
> "Further, they seem to be incapable of taking actions based on principles; they tend rather to cure only the examples which illustrate the principles. Or else they are always seeking for precise rules to solve imprecise situations--in other words, they act as clerks, not as officials. Example: the suggestion by the Navy Review Team that the Armed Services Procurement Regulations be modified to specify the desired level of accuracy for labor charges on Government contracts.
>
> "I have entered into this series of criticisms because the way the Navy is doing business is wasteful of Government funds and therefore does not permit us to build as many ships as we otherwise could. My object is not the vain effort to make contractor live up to their contracts with proper accounting, procurement and cost control practices, or to make Government officials do the jobs they are paid to do. It is to obtain the maximum defense possible for the United States."

3. For the above reasons I recommend that you assign to a separate individual in NAVCOMPT the overall responsibility for developing and implementing effective cost controls under Navy shipbuilding contracts. This individual should seek whatever assistance he needs from other organizations, within and without the Navy.

4. It is plain that much effort has gone into the NAVCOMPT Special Review Team report. But the fact nevertheless remains that it has been over a year since the Vice Chief of Naval Operations requested NAVCOMPT to look into this matter, and over 18 months since I first reported the problem. Ahead are further potential and probable delays: NAVCOMPT review of comments by the Naval Ship Systems Command and the Chief of Naval Material; submission of the report and accompanying comments to the Chief of Naval Operations; establishment of a group to write cost control system criteria; studying practices at other shipyards; obtaining comments on that team report; and so on. Meanwhile the Navy is doing practically nothing to establish and enforce effective cost controls.

5. If the Navy is to realize any good from this effort, a sense of propriety and urgency is needed. The nagging question is whether the people who like to talk about cost control can think of anything to do but talk about it. They want to talk about issues for years on end. To decide an issue quickly would deprive them of anything to keep on talking about, and there would be no job for them or for their numerous assistants. This situation results in a distorted picture of official responsibility, damaging not only to the officials concerned but to the Navy itself.

6. Unless this issue is handled in the business-like way required under the circumstances, you will get nothing but more studies and excuses. If Congress then, as it no doubt will, "takes off" at the Navy, we will have demonstrated that we are incompetent to do our own job. If supervision of Navy contracts is, in consequence, turned over to an outside agency, we ourselves will have been responsible.

7. The time has come to stop fruitless studying of what our job is and start doing it. A man should learn what his job is, either prior to assuming it or shortly thereafter. If it takes him his entire working life to learn what his job is, it would be better to assign him duties having no responsibility and to pay him accordingly.

I am sure we do not want said of us what Czar Nicholas I said of his government: "Not I but 10,000 clerks rule Russia."

H. G. Rickover

H. G. Rickover

Copy to:
Vice Chief of Naval Operations
Assistant Secretary of the Navy (Installations & Logistics)
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H - 1407
4 FEB 1971

MEMORANDUM FOR COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Cost control and procurement deficiencies at Electric Boat Division of General Dynamics and Newport News Shipbuilding and Dry Dock Company

1. I just learned that on 11 January 1971 you sent to Mr. Pierce, the General Manager of Electric Boat, and Mr. Ackerman, President of Newport News, several of my reports on their shipyards. In a forwarding letter you noted that my reports constitute "one view within the Navy" of the state of cost control at private shipbuilders. You stated that no detailed response was requested, but invited Messrs. Pierce and Ackerman to offer their views as to what the major cost control problems at their yards are, and what should be done to correct them. I was not consulted when your letter was being prepared, nor was I sent a copy of the letter after it was signed.

2. It has been more than two years since I began pointing out the serious deficiencies in procurement and cost control practices at Newport News and Electric Boat and in the Navy's administration of its shipbuilding contracts at these shipyards. As a result of my reports, several other Navy offices--including the Comptroller of the Navy, the Naval Material Command, and the Naval Ship Systems Command (NAVSHIPS)--have undertaken studies of their own and have found the same discrepancies. As a result of these reviews, the Assistant Secretary of the Navy (Installation and Logistics) last August directed that the Navy initiate a policy of diligent contract administration in contrast to the so-called "disengagement policy" which NAVSHIPS indicated had inhibited its contract administration efforts in the past. The Comptroller of the Navy's recent report on cost control urged prompt action to establish effective cost control at private shipyards.

3. Despite the numerous studies and reviews the Navy has made during the past two years, little has been accomplished. Each review has resulted in a list of deficiencies and an action plan for correction. However, most of the issues raised with the contractors have not gone to the root of the problem. Moreover, the Navy's actions have been disjointed. The fact that your letter was not coordinated among the Navy offices involved--not even within NAVSHIPS--is typical of the Navy's efforts to date in this matter.

4. The expression "one view within the Navy" can indicate that you have disassociated yourself from my criticism of the contractors. It will cause these contractors to persist in delaying correction of deficiencies at their yards. Since I started reporting these issues, many in NAVSHIPS have attempted to discredit them; these attempts have not been successful. I think it is high time for this command to associate itself with efforts to improve the shipyards; after all, this is NAVSHIPS' direct responsibility. NAVSHIPS cannot continue to stand by as a disinterested observer.

5. It would seem to me that by now the Navy should be able to confront senior management at the major shipyards with a coordinated statement of what the Navy considers to be wrong with the contractors' operations and what corrective action is needed. Instead of soliciting opinions from shipyards as to the action that should be taken, the Navy must decide for itself what it wants. Specifically, NAVSHIPS should:

a. Identify the major issues, not the procedural deficiencies, from prior reports;

b. Develop an articulate statement of these issues, obtaining concurrences where appropriate from the Comptroller of the Navy, the Naval Material Command, and internally within NAVSHIPS;

c. Raise these issues formally with senior shipyard management and obtain firm commitments for corrective action together with specific dates for accomplishment;

d. Set up a system of close surveillance to ensure corrective action is taken.

I will be glad to assist you in taking such actions.

6. In your letters to Messrs. Pierce and Ackerman you indicated that you had deleted some material from my reports in the copies you sent them. I would appreciate receiving a copy of the edited versions of my reports which were transmitted to the two shipyards.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy (Installation & Logistics)
Assistant Secretary of the Navy (Financial Management)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H - 1438
14 April 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Deficiencies in the Procurement of Nickel Alloy Materials
by Newport News Shipbuilding and Dry Dock Company

Ref: (a) Deputy Commander for Nuclear Propulsion Memorandum
to the Assistant Secretary of the Navy (Installations
& Logistics) Ser 08H-1337 of 30 April 1969
(b) Deputy Commander for Nuclear Propulsion Memorandum
to Commander, Naval Ship Systems Command,
Ser 08H-01354 of 23 September 1969
(c) Deputy Commander for Nuclear Propulsion Memorandum
to Commander, Naval Ship Systems Command,
Ser 08H-1394 of 23 October 1969
(d) Deputy Commander for Nuclear Propulsion Memorandum
to Commander, Naval Ship Systems Command,
Ser 08H-6403 of 23 December 1969
(e) Deputy Commander for Nuclear Propulsion Memorandum
to Commander, Naval Ship Systems Command,
Ser 08H-780 of 13 October 1970

Encl: (1) Report of Practices Used by Newport News Shipbuilding
and Dry Dock Company to Procure Nickel Alloy Material
for Construction of CVAN 68 and DLGN 36

1. In references (a) through (d), I identified major deficiencies in procurement practices and cost controls at Newport News Shipbuilding and Dry Dock Company. I pointed out that these deficiencies were responsible for wasting millions of dollars each year, and were impairing the Navy's ability to obtain the ships it vitally needs. Also, I urged the Navy to take prompt and adequate corrective actions. In reference (e), I pointed out the lack of progress being made in establishing an effective form of cost control for Newport News' work on government contracts and the Navy's failure to require Newport News to enforce the Truth-in-Negotiations Act in its material procurements for Navy contracts.

2. Enclosure (1) is a report concerning the deficiencies in the Newport News procurement of nickel alloy material used in the construction of CVAN 68 and DLGN 36. The report shows:

a. Newport News is buying substantial quantities of nickel alloy materials through area distributors and paying the distributors' markups even in cases where the distributors provide no service and the shipyard deals directly with product manufacturers to resolve pricing, delivery and technical matters.

b. Newport News is not obtaining and evaluating cost and pricing data from nickel alloy material vendors as required by the Truth-in-Negotiations Act. Newport News is evading the requirements of the Truth-in-Negotiations Act by determining that "adequate price competition" exists in procurements which are in fact sole source procurements from a single manufacturer.

Newport News' purchase orders with area distributors for nickel alloy materials required for Navy contracts currently amount to nearly a million dollars. The total of Newport News' purchase orders with area distributors for all types of materials required for Navy contracts is approximately $3.5 million. It appears from the attached report that a savings of 5 to 15 percent could be realized by buying these materials directly from manufacturers and eliminating the markup to distributors. While the potential savings is not large in comparison to overall material procurement costs at Newport News, the deficiencies indicate that Newport News has not taken effective action to identify and correct defective procurement practices and is not complying with the Truth-in-Negotiations Act.

3. I am bringing this matter to your attention so that appropriate corrective actions may be taken at Newport News. Specifically, I recommend that:

a. Newport News establish procurement policies that ensure that all materials and equipment are obtained from the least cost source.

b. Newport News require cost and pricing data in procurements where all vendors are dependent upon a single manufacturer for the basic product.

c. Newport News negotiate with manufacturers to obtain materials at the same prices manufacturers offer to area distributors.

d. SUPSHIPS at Newport News devote more attention to Newport News cost control and procurement practices.

e. NAVSHIPS take steps to require Newport News to enforce the Truth-in-Negotiations Act.

f. NAVSHIPS request the Defense Contract Audit Agency or if necessary the General Accounting Office to audit the actual cost records of the Huntington Alloy Division of International Nickel Company to determine the costs and profits on nickel alloy materials sold to the Navy and its shipbuilders.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material

REPORT OF PRACTICES USED BY NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY TO PROCURE NICKEL ALLOY MATERIAL FOR CONSTRUCTION OF CVAN 68 AND DLGN 36

Summary

A review conducted in 1969 disclosed several major deficiencies in the practices employed by Newport News in purchasing hull steel required in naval ship construction programs. This review also disclosed that Newport News was not obtaining and evaluating cost and pricing data from steel suppliers as required by the Truth-in-Negotiations Act. A recent review of shipyard nickel alloy materials procurements disclosed what also appear to be major deficiencies in the shipyard's procurement practices for materials used in construction of CVAN 68 and DLGN 36. The review covered about 50 shipyard nickel alloy material procurements and identified the following deficiencies:

a. Newport News is buying substantial quantities of nickel alloy materials through area distributors and paying the distributors' markups even in cases where the distributors provide no service and the shipyard deals directly with product manufacturers to resolve pricing, delivery and technical matters.

b. Newport News is not obtaining and evaluating cost and pricing data from nickel alloy material vendors as required by the Truth-in-Negotiations Act. Newport News is evading the requirements of the Truth-in-Negotiations Act by determining that "adequate price competition" exists in procurements which are in fact sole source procurements from a single manufacturer.

Procurement of Nickel Alloy and Other Materials Through Distributors

The following is a description of the manner in which most nickel alloy pipe and fitting products are purchased by Newport News. It was developed from a review of Newport News purchase orders and Navy purchasing files. There is only limited competition among the suppliers of nickel alloy materials. Newport News buys these materials, many of which are unique to nuclear ship construction, from distributors rather than directly from manufacturers. This practice is a factor contributing to higher costs on Navy shipbuilding contracts.

Over 90% of the shipyard's requirements for nickel are supplied by one producer, International Nickel Company of Canada (INCO). The principal buyer of this raw material from INCO is Huntington Alloy Products, a division of INCO. Huntington markets nickel alloy products in three ways:

1. It sells finished nickel alloy products directly to the shipyard;
2. It sells finished products through distributors to the shipyard;
3. It sells semi-finished products to specific pipe and fitting manufacturers--principally Chemetron and Gulf and Western--who in turn sell the finished product, usually through area distributors, to the shipyard.

A principal finding of the review is that area distributors do not provide marketing services that would justify the shipyard in paying prices for nickel alloy products that include a distributor's markup. Specifically:

1. In 35 purchase orders reviewed, material was not provided from the area distributor's inventory. Instead the material was manufactured and shipped directly from the firm represented by the area distributor.
2. Questions regarding pricing, delivery, and technical ordering data were in most cases resolved by the shipyard directly with the manufacturer, not the distributor.
3. Two or three area distributors often represent the same manufacturer and at times quote identical prices.
4. Discrepant material received by the shipyard was returned directly to the manufacturer, not the distributor.
5. Manufacturers did not underbid their distributors. Whenever both the manufacturer and his distributors quoted on a Newport News purchase order, the manufacturer's price was either identical to or higher than the prices quoted by the distributors. There are no indications that Newport News has attempted to obtain materials at the same prices manufacturers offer to area distributors. Moreover, manufacturers on occasion requested that Newport News purchase materials from an area distributor in order that the distributor could receive the manufacturer's discount.

A brief check of purchase orders for other types of material indicates that the above circumstances are not unique to the procurement of nickel alloy material. Newport News purchase orders with area distributors for materials required for Navy contracts currently totals approximately $3.5 million and include purchase orders of nearly a million dollars for nickel alloy products. The products furnished by these distributors extended from specialty steels to such commonly used items as hoists and plumbing fixtures. Newport News buys these products in such large quantities that it could exert significant bargaining power in direct dealings with the manufacturers.

It was not possible to determine the premium the shipyard pays as a result of purchasing through distributors instead of directly from manufacturers. However, it is reasonable to assume that savings of from 5 to 15 percent (the normal range of distributors' markups) could be saved by buying directly and avoiding the distributor's markup.

Failure to Obtain Supplier Cost and Pricing Data

No record could be found that Newport News has obtained and evaluated cost and pricing data from nickel alloy material vendors as required by the Truth-in-Negotiations Act, PL 87-653. The purchase order files indicate the following:

1. For purchase orders over $100,000, raw material suppliers such as International Nickel have apparently not been requested to furnish cost and pricing data.
2. Newport News has avoided the requirement to obtain cost and pricing data by determining that "adequate price competition" is obtained by purchasing from distributors,

even though all are dependent on the same manufacturer. The determination is clearly erroneous in these circumstances. Regardless of which supplier is awarded the order, the result is a sole source procurement to one manufacturer.

3. On the one occasion Newport News requested the Huntington Alloy Division of International Nickel Company to provide cost data, Huntington refused. Huntington's reply, dated 20 September 1969, states:

> "We are unable to comply. We consider our cost and pricing data to be proprietary information which, as a matter of company policy, we do not disclose to customers or competitors. We certify that the prices and terms set forth in this quotation are as low as any accorded by us to our most favored customers for like materials and services under comparable conditions. We further certify that our pricing procedures for similar products have been audited by GAO and found acceptable."

Despite certifications such as this, Huntington's prices to Newport News are not as low as those offered to distributors. Even if Huntington did sell material to Newport News at the same price offered to distributors, that would not eliminate the requirement to provide cost and pricing data in compliance with the Truth-in-Negotiations Act.

Conclusions

Newport News' practice of buying material through area distributors instead of purchasing directly from manufacturers may be unnecessarily increasing material costs under Navy contracts by 5 to 15 percent.

Newport News is not taking maximum advantage of its potential bargaining power to obtain the lowest possible prices for material by buying directly from manufacturers. Furthermore, Newport News has, in circumstances where competition is clearly lacking or limited, classified procurements as "competitive", thereby avoiding the requirement to obtain and evaluate cost and pricing data. Newport News has not diligently sought to make suppliers comply with the requirements of the Truth-in-Negotiations Act.

To correct these procurement deficiencies I recommend that:

1. Newport News establish procurement policies that ensure that all materials and equipment are obtained directly from manufacturers unless distributors provide services that would justify a markup to the distributors.
2. In judging the adequacy of competition, Newport News look beyond the mere number of suppliers to the basic nature of the procurement. If, in fact a procurement is non-competitive, it should be so classified. Prices received from two or more distributors, all of whom are dependent on a single source, should not be treated as competitive prices.
3. Newport News obtain appropriate vendor cost and pricing data as required by the Truth-in-Negotiations Act.
4. Newport News negotiate with manufacturers to obtain materials at the same prices manufacturers offer to area distributors.

5. The Supervisor of Shipbuilding take immediate action to require Newport News to obtain and use supplier's cost and pricing data for materials and equipment procured under circumstances of limited competition.
6. NAVSHIPS arrange with the Defense Contract Audit Agency or if necessary the General Accounting Office to audit the actual cost records of the Huntington Alloy Division of International Nickel Company to determine what costs are being incurred and what profits are being made on nickel alloy materials sold to the Navy and its shipbuilders.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
0523:STG:dsr
Ser 68-0523

7 JUN 1971

MEMORANDUM FOR DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: Deficiencies in the Procurement of Nickel Alloy Materials by Newport News Shipbuilding and Dry Dock Company, information concerning; transmittal of

Ref: (a) Deputy Commander for Nuclear Propulsion Memorandum 08H-1438 of 14 Apr 1971 to Commander, Naval Ship Systems Command
(b) NAVSHIPSYSCOMHQ ltr 0523:STG:dsr Ser 45-0523 of 23 Apr 1971
(c) Fonecon G. Morrison (SUPSHIP Newport News) and T. Gets (NAVSHIPS 0523) of 2 Jun 1971

Encl: (1) Copy of SUPSHIP Newport News ltr GEN/4200 Ser 400-116 of 20 May 1971

1. Reference (a) apprised this Headquarters of deficiencies, noted by a representative of your staff, in the procurement of Nickel Alloy Materials by the Newport News Shipbuilding and Dry Dock Company for construction of the CVA(N) 68 and the DLG(N) 36.

2. By reference (b), a copy of which was provided your Directorate, SUPSHIP Newport News was requested to take certain actions and to inform this Command of the results thereof.

3. Enclosure (1) represents SUPSHIP Newport News initial report of actions taken to date. As additional reports are received, a copy of each such report will be provided your Directorate.

4. Based on information received during reference (c), the submission of the interim report mentioned in paragraph 11 of enclosure (1) will be delayed approximately two (2) weeks.

N Sonenshein

N. Sonenshein
Rear Admiral, USN
Commander, Naval Ship Systems Command

Copy to:
SUPSHIP NN (w/o encl)

GEN/4200
Ser 400-116
20 MAY 1971

From: Supervisor of Shipbuilding, Conversion and Repair, USN
Newport News, Virginia 23607
To: Commander, Naval Ship Systems Command

Subj: Deficiencies in the Procurement of Nickel Alloy Materials by Newport News Shipbuilding and Dry Dock Company

Ref: (a) NAVSHIPS ltr Ser 45-0523 of 23 Apr 1971
(b) Deputy Commander for Nuclear Propulsion memorandum 08H-1438 of 14 Apr 1971 to Commander, Naval Ship Systems Command
(c) Discussions between Mr. T. Banka, GAO Washington; Mr. H. Pratt, GAO NORVA; and CDR D. Potter, SUPSHIP NN of 7 May 1971

Encl: (1) SUPSHIP NN ltr Ser 400F-105 of 27 Apr 1971
(2) NNS&DDCo ltr of 3 May 1971 to SUPSHIP NN
(3) NNS&DDCo ltr of 30 Apr 1970 to Huntington Alloy
(4) NNS&DDCo ltr of 6 May 1971 to INCO, N. Y.
(5) NNS&DDCo ltr of 6 May 1971 to A. M. Castle
(6) NNS&DDCo ltr of 6 May 1971 to Metal Goods
(7) NNS&DDCo ltr of 6 May 1971 to J. M. Tull
(8) NNS&DDCo ltr of 5 May 1971 to Tube Turns
(9) Huntington Alloy ltr of 26 Sep 1969 to NNS&DDCo
(10) NNS&DDCo ltr of 22 Aug 1969 to Huntington Alloy
(11) SUPSHIP NN ltr Ser 400C-110A of 12 May 1971
(12) SUPSHIP NN ltr Ser 400-109 of 12 May 1971
(13) SUPSHIP NN ltr Ser 400-111 of 12 May 1971
(14) SUPSHIP NN ltr Ser 400-112 of 12 May 1971
(15) SUPSHIP NN ltr Ser 400-113 of 12 May 1971
(16) SUPSHIP NN ltr Ser 400-114 of 12 May 1971
(17) SUPSHIP NN ltr Ser 400-115 of 12 May 1971

1. Reference (a) and the enclosure thereto (reference (b)) apprised the Supervisor of deficiencies in the procurement of nickel alloy materials by the Newport News Shipbuilding and Dry Dock Company. Further, reference (a) requested that the Supervisor:

a. "Comment on the SUPSHIP's knowledge of the stated deficiencies and what measures have been taken by the SUPSHIP to assure alleviation of the problem(s)".

b. "Prepare a letter to the Newport News Shipbuilding and Dry Dock Company denoting the reported deficiencies, and solicit their comments concerning them as well as a statement of corrective actions that have been or are to be, taken to alleviate a re-occurrence of same."

GEN/4200
20 MAY 1971

Subj: Deficiencies in the Procurement of Nickel Alloy Materials by Newport News Shipbuilding and Dry Dock Company

2. Enclosure (1) was hand-carried to the contractor's Acting President on 27 April 1971. In this meeting, interest and cooperative intent on the part of Newport News Shipbuilding and Dry Dock Company were displayed.

3. A SUPSHIP Procurement System Review Team was designated on 27 April 1971 and assigned responsibility for reviewing the contractor's procurements of nickel alloy products in light of the information provided by reference (b). This seven member team is headed by a senior Supervisory Contract Specialist and is staffed by representatives of the Contracts Department, Planning Department, and Quality Assurance Department as well as an advisor from the office of the Resident Auditor, Defense Contract Audit Agency.

4. On 28 April 1971, the SUPSHIP Contracts Officer met with the contractor's Director of Material Management, Purchasing Agent, and Assistant Purchasing Agent. The members of the review team were introduced and arrangements were made for access to documents, working space and company assistance and participation.

5. The review team commenced full time operation on 29 April 1971. As deficiencies are discovered, informal recommendations for corrective action are being made directly to the supervisory personnel involved. All major deficiencies are being documented and will be included in a report to be submitted upon completion of the review. A formal letter setting forth all deficiencies noted and required corrective action will also be directed to the contractor at that time.

6. Enclosure (2) is the contractor's interim response to enclosure (1). It should be noted that this letter sets forth the contractor's stated policy regarding dealing with distributors. The review team is verifying procurement actions under this policy as a part of their review plan. Subsequently, a much stronger policy has been stated by the President of the Company.

7. Enclosures (3) through (7) are the contractor's requests for cost and pricing data. It is anticipated that additional firms will be identified during the review whose sub-contract dollar volumes are nearing or have exceeded the thresholds of the Truth-in-Negotiations Act (PL 87-653) with regard to certified cost and pricing data. As such firms are identified, additional requests similar to these enclosures will be released. It should be noted that these enclosures contain language permitting the submission of cost and pricing data directly to the government and also requiring documentation for any claimed exemptions from PL 87-653. This phraseology was intended to preclude negative responses on either of these grounds which would then require additional follow-up correspondence.

GEN/4200
Ser 400-116
20 MA, 1971

Subj: Deficiencies in the Procurement of Nickel Alloy Materials by Newport News Shipbuilding and Dry Dock Company

8. Enclosure (8) is the contractor's request for reconsideration of previously stated policy regarding the exclusive use of distributors by one firm which has consistently refused to sell direct. Additional firms may be identified, during the course of the review, which have adopted the same policy. In this event, additional letters similar to this enclosure will be released.

9. Enclosures (9) and (10) represent an earlier attempt to obtain cost and pricing data for the Huntington Alloy Division of the International Nickel Company. Since enclosure (10) refers to an audit of pricing procedures by the General Accounting Office, the reference (c) discussions resulted in an agreement by representatives of the General Accounting Office to provide this office with copies of any reports available on this subject. Enclosure (11) is a request to the Defense Contract Audit Agency for copies of any reports issued by that agency concerning this same firm.

10. Enclosures (12) through (17) are addressed to other government procurement offices known to be involved in the procurement of nickel alloy products. Telephone conversations with purchasing officials of the addressee activities, which preceded the release of this series of enclosures, reveal the prevalence of similar problems, in varying degrees, at government procurement activities. However, it is felt that this series of enclosures could:

a. Identify additional potential sources which will be provided to the prime contractor to assist in broadening his competitive base.

b. Help to surface widespread problems endemic to the nickel alloy industry which could then be approached on a government-wide basis.

11. This letter is intended as an interim response to reference (a). Further actions will be predicated upon the responses received to enclosures (3) through (8) and (11) through (17), and the final results of the detailed review still under way. It is anticipated that another interim report will be submitted by 28 May 1971 and a final report will be submitted by 14 June 1971.

J. D. EVANS
Acting

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1450
6 May 1971

MEMORANDUM FOR THE DEPUTY CHIEF OF NAVAL MATERIAL
(PROCUREMENT AND PRODUCTION)

Subj: Excessive profit rates on Naval Ship Systems Command (NAVSHIPS) contracts with General Dynamics Corporation, Electric Boat Division for SSBN Poseidon Missile Conversions

Ref:
(a) Director Navy Area Audit Service Boston Report A10040 dated 29 January 1971
(b) Assistant Deputy Chief of Naval Material Route Sheet to Mr. M. C. Greer, SHIPS 08 undated (received 22 April 1971)
(c) NAVSHIPS 08 memorandum 08H-786 dtd 30 October 1970 to ASN(I&L)

1. Reference (a) reports the results of a Naval Audit Service review of negotiated target incentive fees under three NAVSHIPS cost-plus-incentive-fee (CPIF) Poseidon missile conversion contracts with Electric Boat. The three contracts provided negotiated target fees totaling $10.9 million based on target costs of $112.2 million, or about 9.7 percent on costs. From its calculations using the Armed Services Procurement Regulation weighted guidelines method for calculating profits, the Naval Audit Service concluded that these target fees on these three contracts were excessive and should be reduced to about 7.7 percent.

2. Reference (b) requested NAVSHIPS 08 comments on reference (a) and on a route sheet comment by the NAVMAT Director of Procurement Control and Clearance Division that:

> "So far as this office (MAT 022) is concerned, 9.7 percent fee earned on a Poseidon overhaul and conversion is money well spent and not excessive".

3. In reference (c) NAVSHIPS 08 pointed out that:

a. Electric Boat's costs on three Poseidon conversion contracts were about 45 percent greater than Newport News' costs for comparable work.

b. Despite these higher costs, the Navy paid about $1.4 million more profit to Electric Boat than to Newport News--about 18 percent more profit to the shipbuilder having the higher costs.

c. Actual profits on these Poseidon conversion contracts exceeded 10.9 percent due to the incentive profit feature in these contracts. NAVSHIPS 08 questioned why the Navy was contracting on a basis which permitted profits of 10-13 percent on cost reimbursement type contracts on which the shipbuilders have no risk of financial loss.

4. A 9.7 percent fee on a no-risk contract seems excessive from a return on investment standpoint. In 1970, Electric Boat's work for the Navy totaled about $234 million and produced a profit of nearly $24 million. Based on nongovernment-owned assets of about $60 million and a net worth of about $47 million, the following table compares Electric Boat's 1970 actual profit rates with the 9.7 percent average profit on costs negotiated by the Navy and the 7.7 percent profit on costs suggested by the Naval Audit Service.

	E. B. Actual 1970 Profit	Navy Negotiated Profit	Audit Service Suggested Profit
Percent Profit on Costs	11.2%	9.7%	7.7%
Profit as a Percentage of Net Assets	40.0%	34.0%	27.0%
Profit as a Percentage of Net Worth (Calculated)	51.0%	44.0%	35.0%

5. The amount of nuclear work involved in a Poseidon conversion contract is relatively small and a large portion of the total conversion costs are not under my technical control. However, based on my extensive nuclear shipbuilding and overhaul experience I agree with the Naval Audit Service that a 9.7 percent profit on these contracts is excessive. Even the 7.7 percent profit on costs recommended by the Navy Audit Service results in a return on investment that is almost twice the average return on investment indicated in Fortune's 1970 survey of the 500 largest industrial concerns. Thus, I disagree with the statement by MAT 022 that a "9.7 percent fee earned on a Poseidon overhaul and conversion is money well spent and not excessive." A fee of 7.7 percent seems more liberal than warranted considering the high costs of doing work at Electric Boat, the contractor's minimal investment, and no-risk contracts. A fee of about 5 percent would provide Electric Boat a return on its total assets of 17.5 percent and a return on net worth of about 22 percent with little or no risk to the contractor.

6. From the above, I believe it is clear that Navy profit policies for ship construction and overhaul contracts need immediate and substantial revision. In view of the special considerations pertaining to shipbuilding work, i.e., a high percentage of sole and limited source contracts, widely varying costs of performance, and special contract provisions limiting shipbuilder risk, NAVSHIPS cannot rely on the weighted guidelines method of profit computation to establish proper profit levels on ship construction and overhaul contracts. These special considerations, together with shipbuilder capability, efficiency, and investment must be taken in to account in establishing appropriate profit policies for shipbuilding work.

H. G. Rickover

H. G. Rickover

cc:
COMNAVSHIPS
NAVSHIPS (02)
ASN(I&L)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1400
4 Jun 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Need for Improved Controls over Change Order Pricing at the General Dynamics Corporation's Electric Boat Division

Encl: (1) Pittsburgh Naval Reactors Representative, Groton, Memorandum dated May 28, 1971

1. Enclosure (1) is a memorandum recently received from my field representatives at Electric Boat. It indicates that Electric Boat has overcharged the Government on a recent shipbuilding contract change by misrepresenting, during negotiation, the basis upon which the work would be performed.

2. From the information contained in enclosure (1) it appears that NAVSHIPS should be entitled to a price reduction from Electric Boat for this particular change. Moreover, the facts in this case confirm several points I have raised previously; namely:

a. Existing procedures are not adequate to preclude overpayment on changes at Electric Boat.

b. Under the present system, the Government is at a substantial disadvantage in negotiating and settling change orders because in pricing changes the Government must depend primarily on the contractor's estimates and his representation of the facts.

c. Shipbuilders should be required to keep track of the cost of large changes separately so that there is a firm basis for checking the reasonableness of prices negotiated and so that both the Navy and the shipbuilder will know what costs have actually been incurred.

3. Based on the above, I recommend that NAVSHIPS take the following action:

a. Obtain an appropriate price reduction from Electric Boat for the change order in question on the basis that the information provided by Electric Boat during negotiations was not current, complete and accurate as required by the Truth-in-Negotiations Act.

b. Insist that major changes be handled under a cost separation shop order so that actual costs can be compared with negotiated prices for all significant changes.

c. Set up a system of spot checks to ensure that Electric Boat pricing of proposals for changed work are in fact consistent with the way the work will be performed.

4. I would appreciate being kept advised of what action NAVSHIPS intends to take in this matter.

H. G. Rickover

Copy to:
NAVSHIPS 02
NAVSHIPS 05

UNITED STATES GOVERNMENT

Memorandum

TO : VADM H. G. Rickover, USN

DATE: May 28, 1971

FROM : E. J. Siskin, Naval Reactors Representative
Electric Boat, Groton, Ct.

SUBJECT: EXCESSIVE COST OF SILVERSIDES (SSN 679) MAIN COOLANT PUMP VOLUTE MODIFICATION

SYMBOL: PNRO/SNRO Rep., Groton EJS #557

1. NAVSHIPS letter, serial 08T-0836 of March 3, 1971, authorized the subject work at a cost not to exceed $60,000.

At that time, I advised you that Supervisor of Shipbuilding (SUPSHIPS) personnel were preparing to issue a maximum price unilateral change for this work. Based on my discussions with the Supervisor, he subsequently agreed to try to negotiate a firm price deal in advance of actual start of work. I agreed to have the Bettis office and my office give the SUPSHIP's negotiating people necessary information to assist their efforts. This turned out to be highly desireable, since no SUPSHIPS people actually observed either the mockup work for this job or actual job site and, thus, had no real idea of the work involved. For example, the SUPSHIPS contract estimator was proceeding with his estimate on the basis of the pumps already being installed in the volute. A quick observation of the intended work area would have made it very clear to him that the pumps were not yet installed.

2. The original Electric Boat (EB) estimate was $60,451. The estimate was based on assigning all required people (cleaners, inspectors, riggers, etc.) exclusively to this work. When SUPSHIPS, at our prompting, asked EB why such people couldn't be assigned on an as-needed basis, EB indicated that this was simply not possible for a job so complex. EB did agree, however, that excessive time was being allowed for machinists and a few other trades and agreed to reduce the total price to $49,291. However, no specific breakdown of manpower was provided with this price. SUPSHIPS bought in on this latter price.

3. Since, as I advised you at the time, I still considered the price much too high, my people and I closely followed this job in order to determine how many people were actually used. Based on about 60 hours of observations (spot checks of nearly all shifts during the 4 weeks of work) and checking work logs, the following is the estimated actual manhours of this job as compared with EB's initial estimate. Also noted are the manhours currently shown in EB's labor control records for this completed job.

Trade or Department	Manhours in Electric Boat's Original Proposal (1)	Estimated Manhours Worked Based on Observations (2)	Actual Manhours Charged to This Job
Riggers	1168	102	45½
Machinists	2204	1146	1330¼
Cleaners & Painters	808	68	83½
Nuclear Quality Control	792	170	0
Grinders	496	396	262
Electricians	16	16	0
Carpenters	32	32	7
Sheet Metal	16	30	89¼
Production Control	40	40	0
Work Authorization Control	8	8	0
Construction Change Evaluation	120	120	0
Nuclear Construction & Repair (Support)	120	120	0
Stores	6	6	0
Change Control	116	116	0
Tool Makers	0	0	23½ (3)
Welders	0	0	8 (3)
Guards	0	0	54 3/4(
Process Control	0	0	½
Total Manhours	5942	2370	1904½
Total Material	$500	$500	

NOTES:

(1) The numbers appearing in the "Man-hours in Electric Boat's Original Proposal" column were the basis for the initial price of $60,451. Subsequently, the price was reduced to $49,291 and the reduction was attributed primarily to a reduction in machinist man-hours.

(2) The numbers appearing in the "Estimated Man-hours Worked based on Observations" column are considered to be liberal estimates of actual man-hours. For example, there was no way to observe the man-hours contributed by the engineering support and administrative groups to the subject job. Therefore, the Electric Boat man-hour estimates for these support groups were accepted. However, I suspect that very little effort was required by these groups and what little they did contribute was charged to overhead.

(3) The special tooling required for this job was obtained under separate contract with the Bettis Atomic Power Laboratory and there were no known requirements for tool makers. Also no guards and welders were observed working on this job and there were no known requirements for these people. As a result, the basis for these changes is questionable.

4. I believe the man-hours estimates based on observations by my people are within 10% of the actual man-hours worked on this change order and are perhaps on the high side. Allowing a 10% contingency and a suitable profit, the actual price for this work should have been no more than $30,000. The reason for the disparity between my $30,000 and Electric Boat's $49,291 price is principally that support trades were only assigned on an as required basis right from the beginning, despite the EB negotiator's protestation to the contrary. I have no way to determine whether the difference between what EB said they are going to do and what they actually did was due to poor communications between negotiators and trades or whether the estimates were deliberately inflated.

5. This job resulted in a direct increase in the SILVERSIDES construction contract. I intended to bring this matter to SUPSHIPS attention and to request SUPSHIPS to obtain a price reduction from Electric Boat based on the submission of false and misleading cost data. However, considering the discrepancies and inconsistencies in the pricing of this relatively inexpensive change order, I feel the implications are such that you may wish to bring this matter to the attention of Navy officials.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1478
14 July 1971

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Excessive Progress Payments on Nuclear Shipbuilding Contracts at Newport News Shipbuilding and Dry Dock Company

1. On several occasions in the past, I have written to you regarding deficiencies in shipbuilder procurement and cost control practices and in Navy management of shipbuilding contracts at Electric Boat Division of General Dynamics Corporation and at Newport News Shipbuilding and Dry Dock Company. In addition, I have pointed out that progress payments on most major Navy shipbuilding contracts are more liberal than on other contracts for military equipment and I cited examples showing that loose government administration of progress payments is allowing shipbuilders to obtain what are in effect multi-million dollar, interest-free advances of government funds beyond those required to perform Navy contracts.

2. Looking further into Navy progress payments on shipbuilding contracts at Newport News, here is what I find:

a. Under current Navy policies and practices concerning progress payments on shipbuilding contracts, Newport News is receiving progress payments far greater than it actually needs to meet its cash outlays.

b. Newport News has been able to increase its cash surplus by taking advantage of loopholes in the Navy's progress payment policies and procedures.

c. The Navy does not regularly obtain and review all financial information necessary to evaluate properly Newport News' financial condition and cash flow requirements.

3. The Armed Services Procurement Regulation authorizes the use of progress payments to help finance performance of long-term, high-cost contracts. In most defense work, progress payments are limited to 80 percent of incurred costs, except for small businesses which receive 85 percent. However, progress payments for shipbuilding contracts are more liberal than those available to other defense contractors. Navy fixed price type shipbuilding contracts provide for progress payments based on physical progress, except that such progress payments may not exceed 105 percent of incurred costs. These special progress payment provisions result in the government putting up more working capital than a shipbuilder actually needs to perform its shipbuilding contracts.

4. Possibly these special progress payment provisions were appropriate years ago when shipbuilding contracts usually were awarded on a firm fixed price basis after advertised, competitive bidding. By liquidating part of the contract price as work progressed, the Navy could lessen the financial burden and, in addition, provide the shipbuilder a financial incentive to timely performance. Today, nearly all major shipbuilding contracts are fixed price incentive contracts awarded on a sole source or noncompetitive basis. The Navy bears nearly all of the cost risk on these contracts, and the final contract price is determined after the fact, based on actual incurred costs.

5. The practice of calculating progress payments from physical progress estimates makes it possible for a shipbuilder to get substantially more cash in progress payments than he needs to finance contract work. Although estimates of physical completion made in the field have the appearance of great accuracy, being adjusted from week to week by tenths of one percent, it is impossible to accurately assess the status and interrelationship of hundreds of partially completed tasks spread out over the waterfront and in the shops. Changes and delays further complicate the job. Yet, under present procedures, even slight errors in these estimates can mean millions of dollars difference in the amount of progress payments paid to the shipbuilder. Since estimates of physical completion are inherently imprecise and since the government must review shipbuilder costs under our present contracts, there is no reason to base progress payments principally on estimates of physical progress. In fact, the Navy could avoid overpayment and tie progress payments more closely to the shipbuilder's actual cash requirements by basing progress payments principally on out-of-pocket-costs. Although estimates of actual physical progress are not an accurate basis for determining progress payments, they can serve as an independent check to ensure that progress payments based on out-of-pocket costs do not overcompensate a contractor for work actually performed in the event of contract cost overruns or failure to meet contract delivery schedules.

6. The amount of money Newport News gets over and above that needed to finance work under Navy contracts is substantial. The excess of progress payments over costs on Newport News shipbuilding contracts as of July 9, 1971 was $9.2 million. During the previous six months of 1971 the excess has ranged from $5.2 million to $11.5 million.

7. The surplus working capital at Newport News is quite a bit more than the $5.2 to $11.5 million mentioned above because Newport News includes in its costs items such as:

(1) Non-cash expense such as depreciation of capital assets,

(2) Non-cash accruals for expenses such as workmen's compensation insurance, self-insurance, state and local taxes--items for which Newport News has not yet paid,

(3) The total cost of items that should have been capitalized and written off over a period of years,

(4) The cost of supplies and materials purchased in quantities substantially greater than required for the performance of specific contracts. These materials are charged to government contracts for progress payment purposes and subsequently the contract costs are adjusted when unused materials are declared excess.

8. From information presently available to the government, it is not possible to determine just how much the Navy is paying Newport News over and above actual cash requirements to perform shipbuilding contracts. However, it is obvious that Newport News is obtaining what is, in effect, a large interest-free advance of government funds.

9. Newport News also has taken advantage of loopholes in the Navy's progress payments policies and procedures to increase its cash surplus on Navy contracts. For example, on some major subcontracts, Newport News bills the Navy for 100 percent of the cost of subcontracted work, yet pays to subcontractors progress payments equal to only 90 percent of their incurred costs. The remaining 10 percent is retained by Newport News for months, perhaps years, to cover the correction of defects and to ensure completion of subcontract requirements. This practice currently provides Newport News interest-free use of almost $3.0 million in government funds. Moreover, there is considerable flexibility in how Newport News progress payments are calculated. In December 1970, the method used for the preceding two years to calculate Newport News progress payments on the DLGN 36/37 contract indicated that Newport News had been overpaid by $900,000. However, Newport News arranged with the Navy to apply an alternate method. Under this method, Newport News, instead of having to refund $900,000, was able to claim an additional progress payment of about $3 million.

10. The Navy spends many hundreds of millions of dollars each year in contracts for its major warships. For the protection of the government it is essential that the Navy regularly obtain and review shipbuilder cash flow and other financial information pertinent to the performance of Navy contracts. However, I find that the Navy has taken no steps to do this at Newport News, nor at other major private shipbuilders.

11. I recommend the following:

a. The Navy's standard shipbuilding progress payment procedures should be revised so that shipbuilders provide a reasonable amount of working capital as part of the overall capital investment required to perform Navy shipbuilding contracts. To avoid paying more than the shipbuilder actually spends under Navy contracts, progress payments should be based on out-of-pocket expenses not to exceed actual physical progress. In addition to conserving government funds, such action should give shipbuilders a financial incentive to complete and close out shipbuilding contracts as quickly as possible since their own funds will be involved.

b. Progress payment procedures must be tightened. Shipbuilders should not be permitted to charge the government for material costs in excess of what they pay their suppliers, or to shift from one payment system to another to justify higher progress payments.

c. The Navy must regularly obtain and review all financial information necessary to evaluate properly the financial condition and cash flow requirements of our major private shipbuilders.

12. Today our shipbuilders seem to be devoting far greater attention to financial matters such as cash flow, return on investment, and claims against the government than they are giving to the productivity, efficiency, and economy of this work for the government. Likewise, the Navy itself is largely at fault. It has neglected to face up to its responsibilities. The progress payments issue is only one aspect of the problem. I urge that you keep this in mind in considering the Navy's overall policies with regard to government surveillance of our private shipyards.

13. I would appreciate being kept advised of any action taken as a result of my recommendations.

H G Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Chief of Naval Material
Commander, Naval Ship Systems Command
Office of the General Counsel

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1494
11 Sep 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Employment of Electric Boat Personnel by the Supervisor of Shipbuilding, Groton, Connecticut

Ref: (a) VADM Rickover memorandum of 13 September 1969 on Procurement Practices and Cost Control at Electric Boat Division, General Dynamics Corporation
(b) COMNAVSHIPS memo of 20 January 1970, same subject

1. In reference (a), I pointed out the problem of extensive interchange of personnel between Electric Boat Division, General Dynamics Corporation and the Supervisor of Shipbuilding, (SUPSHIPS) Groton, Connecticut. In reference (b), a response to my report, you indicated that one out of every three SUPSHIPS employees had formerly worked for the shipyard. I have maintained that this situation is not conducive to proper and objective relationships between the Government and Electric Boat.

2. I have subsequently reported numerous other problems at Electric Boat, all of which point to the need for more effective Government surveillance of Electric Boat's work on Navy shipbuilding contracts. During the two years since I began reporting these problems, NAVSHIPS has established new positions in the Supervisor's office to deal with them.

3. I understand that Electric Boat personnel are being recruited to fill some of these positions. For example, the Supervisor of Shipbuilding recently hired a man from Electric Boat's Financial Resources and Data Systems Department to be the SUPSHIPS Program Analysis Officer - a position which involves designing more effective ways of checking Electric Boat operations. It may be that such hiring practices do not violate any laws or regulations; it still seems to me a violation of common sense to place employees in a position where they are expected to review critically the performance of their friends and former colleagues.

4. I am well aware of the standard argument offered in defense of such hiring practices: "Who understands Electric Boat and its weaknesses better than a former Electric Boat employee?"

On this basis it would be entirely proper to hire members of the Mafia to become part of the detective force investigating the Mafia. This position ignores the fact that hiring contractor personnel for an office that must regularly challenge and criticize the contractor puts the Navy, the contractor, and most of all the employees in an awkward position. The problem exists even where there is no clear evidence of favoritism. In situations where personal careers as well as millions of dollars of public funds may be at stake, it is necessary to avoid even the appearance of a conflict of interest. You, of course, appreciate that actions such as these can be the stuff and substance of complaints by news media, columnists and Congress against NAVSHIPS. Elementary prudence and judgement should inhibit such actions by NAVSHIPS officials.

5. For the above reasons, I recommend that NAVSHIPS adopt a policy of not hiring contractor personnel for positions involving contract administration and Government surveillance at activities where they were formerly employed. I would appreciate being advised of what action you intend to take in this matter.

H. G. Rickover

H. G. Rickover

Copy to:
02
05

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
052:TBT:cdt
Ser 281-052

17 JAN 1972

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: Employment of Former Electric Boat Division Personnel by the Supervisor of Shipbuilding, Groton

Ref: (a) SHIPS 08 Memorandum Serial 08H-1494 of 11 Sep 1971
(b) SHIPS 08 Memorandum of 13 Sep 1969
(c) COMNAVSHIPS ltr Ser 2 of 20 Jan 1970

1. In reference (a), you recommended that NAVSHIPS adopt a policy of not hiring contractor personnel for positions involving contract administration and government surveillance at activities where they were formerly employed. Reference (a) is similar to reference (b), in which you recommended that NAVSHIPS issue policy instructions to preclude employment of former contractor personnel in positions where they are responsible for reviewing the operations of their prior employer.

2. I responded to reference (b) by reference (c), in which I said that I considered that proper objective relationships had been maintained in the case of former contractor employees. I also pointed out that I knew of no law or Civil Service regulation that would authorize a prohibition of such employment. In reference (a) you indicated that in your view, the recent hiring of a former employee of the Electric Boat Division by the Supervisor of Shipbuilding, Groton was a violation of common sense even if not contrary to law or regulation.

3. I cannot agree that it is prudent to categorically prohibit the hiring of former contractor personnel. Such a rule might violate existing legislation. I do consider it essential that any such hire be closely scrutinized to avoid a possible conflict of interests.

4. I intend to promulgate a policy to the Supervisors of Shipbuilding which requires that current or recent employment by a contractor be considered as an adverse factor when selecting candidates for positions which require contract administration or government surveillance primarily with that contractor.

5. I have examined the recent employment at Groton in detail. In addition to being procedurally correct, I find that the Supervisor gave careful consideration to the selectee's previous affiliation with Electric Boat Division in his selection decision.

N Sonenshein
N. Sonenshein
[illegible]
Commander, Naval Ship Systems Command

Copy to:
SUPSHIP Groton

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1491

1 5 SEP 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Recurring Deficiencies in Newport News Shipbuilding and Dry Dock Company's Procurement Practices

Ref:
(a) Deputy Commander for Nuclear Propulsion Memo to ASN(I&L) Ser 08H-1337 of 30 Apr 1969
(b) Deputy Commander for Nuclear Propulsion Memo to Commander, NAVSHIPS Ser 08H-1394 of 23 Oct 1969
(c) Deputy Commander for Nuclear Propulsion Memo to Commander, NAVSHIPS Ser 08H-6403 of 23 Dec 1969
(d) Deputy Commander for Nuclear Propulsion Memo to Commander, NAVSHIPS Ser 08H-706 of 29 Jan 1970
(e) Deputy Commander for Nuclear Propulsion Memo to Commander, NAVSHIPS Ser 08H-780 of 13 Oct 1970
(f) Deputy Commander for Nuclear Propulsion Memo to Commander, NAVSHIPS Ser 08H-1438 of 14 Apr 1971

Encl:
(1) NAVSHIPS ltr 022D:DJV:clt Ser 10 of 26 Jan 1971
(2) NAVSHIPS ltr 08H-1416 of 22 Feb 1971
(3) NAVSHIPS ltr 08T-2954 of 19 Mar 1971
(4) NAVSHIPS ltr 08H-1436 of 8 Apr 1971
(5) NAVSHIPS ltr 08H-1452 of 21 May 1971
(6) NAVSHIPS ltr 08H-1493 of 10 Sep 1971

1. References (a) through (f) identified major deficiencies in procurement practices at Newport News Shipbuilding and Dry Dock Company. In these memoranda, I pointed out that without close government surveillance our major shipbuilders have little incentive to reduce costs under shipbuilding contracts. Under today's rules, poor procurement practices do not hurt the shipbuilder because the higher costs can generally be passed on to the Navy. Actually, the high cost of shipyard-furnished components can work to the advantage of the shipbuilder because Navy profit policies reward higher costs with higher profits over the long run.

2. NAVSHIPS' responses state, in effect, that these problems are being resolved through the coordinated actions of NAVSHIPS and the Supervisor of Shipbuilding. Nevertheless, I continue to encounter problems in getting satisfactory procurements from Newport News. For example, since January 1971, I have received five deficient Newport News procurement recommendations for components in the nuclear area alone. Enclosures (1) through (6) are copies of the official NAVSHIPS response to these recommendations. In each case, the deficient Newport News recommendation had to be rejected, or approved subject to further action by Newport News. Among the deficiencies noted were:

a. Newport News did not always obtain cost and pricing data as required by the Truth-in-Negotiations Act in cases where the competition obtained did not appear to be adequate to ensure reasonableness of the proposed price.

b. Newport News did not utilize cost data from previous orders in their cost analysis or in negotiations with the bidders.

c. Proposed costs were not compared with an independent estimate made prior to receipt of bids. Newport News stated "it is not our policy to make such an estimate on equipments of this nature at this point in the procurement."

d. Newport News procurement justifications were inadequate. It was often impossible to determine the reasonableness of the proposed price from the information provided by Newport News. For example, to resolve government audit comments Newport News merely adopted the subcontractor's rationale on questioned items "...without adequately explaining the basis for its conclusions."

3. In some cases Newport News procurement recommendations arrive shortly before the order has to be placed in order to meet ship construction schedules. If the government then discovers deficiencies in the proposed procurements, there is insufficient time to insist that they be corrected prior to order placement. The government is then placed in the position of either agreeing to a poor procurement or delaying the ship. I have too often been placed in that position by Newport News, and I find it unacceptable.

4. Enclosure (6) is an example where insufficient time was allowed for correction of deficiencies prior to required order placement. The original Newport News procurement recommendation was submitted by Newport News on 23 March 1971. On 8 April 1971 NAVSHIPS advised SUPSHIPS that approval was being withheld pending correction of the procurement deficiencies identified by NAVSHIPS. On 7 September 1971, SUPSHIPS advised NAVSHIPS that Newport News had accomplished an acceptable cost analysis and that prompt NAVSHIPS approval was required in order to avoid shipyard delay. However, it was still not apparent that six of the seven procurement deficiencies identified by NAVSHIPS in the 8 April 1971 NAVSHIPS disapproval letter, enclosure (4), had been resolved. Nonetheless, on 10 September 1971, NAVSHIPS had to grant approval to proceed with the proposed purchase order so as to avoid delay.

5. From the deficiencies indicated above, it is obvious that to date NAVSHIPS' efforts to upgrade Newport News' procurements have been largely unproductive and that much attention is needed in this area. The deficiencies indicate ignorance of, or indifference to, fundamental principles of sound procurement. I doubt these deficiencies are confined to the nuclear area.

6. I recommend that NAVSHIPS bring the above deficiencies including the five examples to the attention of Newport News' senior management for corrective action. Specifically, I recommend that NAVSHIPS take prompt steps to ensure that Newport News:

a. Obtains and evaluates supplier cost and pricing data in all cases where the adequacy of competition is questionable.

b. Conducts effective analyses of supplier costs, including reconciliations of proposed costs with detailed independent Newport News estimates, historical cost and pricing data from similar orders, and the results of government audits.

c. Documents its procurement recommendations in sufficient detail that government representatives can determine the reasonableness of the recommended prices without having to rely solely on Newport News "judgment."

d. Submits procurement recommendations to the government at least 60 days prior to the date the contract must be awarded so that the government has a viable alternative to approval of the recommendation on the terms proposed by Newport News.

In addition, NAVSHIPS should establish an effective system of procurement surveillance by government representatives at the shipyard so that less headquarters effort is required in this area.

7. I would appreciate being informed of any action taken in this matter.

H. G. Rickover

Copy to:
NAVSHIPS 02
NAVSHIPS 05

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1495
18 Sep 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Excessive Costs of Nuclear Submarine Overhaul and Conversion Contracts at Electric Boat

Ref:
- (a) Memorandum for ASN (I&L) from Deputy Commander for Nuclear Propulsion dtd 13 Sep 1969
- (b) Memorandum for ASN (I&L) from Deputy Commander for Nuclear Propulsion dtd 15 Jul 1970
- (c) Memorandum for ASN (I&L) from Deputy Commander for Nuclear Propulsion dtd 30 Oct 1970
- (d) COMNAVSHIPS ltr 13-0525 of 28 Apr 1971 to General Manager, Electric Boat
- (e) General Manager, Electric Boat ltr to COMNAVSHIPS dtd 15 Jul 1971

1. In reference (a), I identified serious procurement and cost control deficiencies at the Electric Boat Division, General Dynamics Corporation. In reference (b), I pointed out examples of excessive overhead costs on Navy contracts with Electric Boat. In reference (c), I pointed out that Electric Boat's costs for three SSBN overhaul and conversion contracts were about 45 percent greater than Newport News' for comparable work, but that the Navy had paid $1.4 million more profit--over 18 percent more--to Electric Boat. In reference (d), COMNAVSHIPS advised Electric Boat that an analysis of overhaul costs conducted in response to reference (c) showed Electric Boat's costs were higher than Newport News' in every cost category, with the major difference in overhead costs. In reference (e), Electric Boat replied:

> "We have limited knowledge of the differences in treating direct labor and overhead costs, at the two yards involved. Those differences we are aware of, however, are quite significant and lead us to question the accuracy of a comparative analysis, which was performed in such a short period of time. A high overhead rate of itself is not indicative of anything. Excessive costs can only be eliminated by examining the activities performed by individual departments. Electric Boat has retained the best talent available in an effort to improve efficiency. Given this situation, a general allegation that there are deficiencies is not very helpful to Electric Boat division, if in fact there are

> deficiencies. There has been a fairly constant level of criticism of the Company recently, and we are determined to correct any situation where we are unnecessarily incurring costs. However, in order to do so, we need to know the specific areas where these unnecessary costs are being incurred. The Navy could be very helpful to us in dealing with this matter by being specific in identifying problem areas it is aware of."

NAVSHIPS has not responded to reference (e).

2. The high cost of overhauls at Electric Boat continue to be one of NAVSHIPS' most pressing problems. Recent figures show that we are still paying millions of dollars extra to perform overhaul and conversion work at Electric Boat. NAVSHIPS paid a total of $55.1 million for two conversions (SSBN 632 and 633) completed at Electric Boat this year; Newport News completed two comparable conversions (SSBN 628 and 636) for $44.5 million. A comparison of the cumulative costs of five overhaul and conversion contracts performed by Newport News and five by Electric Boat shows that the Navy has paid a premium of about $40 million to Electric Boat. Despite its higher costs, Electric Boat received $2.6 million more profit--20 percent more profit--than Newport News.

3. Paradoxically, Electric Boat quoted competitive prices for construction of SSN 688 Class submarines. This indicates that Electric Boat can price shipyard work on a par with Newport News where the impetus is great enough. NAVSHIPS, therefore, must take action to provide the impetus for lower costs on overhaul and conversion work at Electric Boat. This has not been done to date.

4. NAVSHIPS and the Supervisor of Shipbuilding have undertaken various studies, set up new staffs, and issued several directives over the last two years. However, I have not seen any substantial improvements at Electric Boat in reducing costs. For example:

- Reference (d) stated that COMNAVSHIPS desired to carry out my previous recommendations calling for the establishment of definitive costing standards at Electric Boat; review and appraisal of the efficiency and effectiveness of each overhead function; lease versus buy analyses; termination of excess personnel; and competitive procurement in overhead purchases. Yet, I have seen little progress in these areas.

- It costs about twice as much to dry dock a submarine at Electric Boat as it costs to dry dock one at Newport News. Yet, no one seems to be working with Electric Boat to try to lower costs in this area.
- Electric Boat has announced some planned facility improvement projects. Most of these projects are aimed at improving productivity and efficiency on fixed price, new construction work where Electric Boat must be competitive to continue to get business. Not much seems to be planned to improve the overhaul facilities where work is done on cost-type contracts. To my knowledge, the Navy has not obtained a commitment from Electric Boat to improve the facilities being used on cost-type overhaul and conversion work.
- Two years ago, in reference (a), I pointed out that Electric Boat's material control system contains serious deficiencies such that the validity of material costs charged to Government contracts cannot be determined; that Electric Boat has not taken effective action to correct the deficiencies in the material control system even after the Government pointed out the seriousness of the problem; that the Government has not taken action to require Electric Boat to provide effective control over material costs. I recommended that the Navy withdraw approval of Electric Boat's accounting system until effective controls are established to preclude mischarging of labor and material costs on Government contracts. A recent Government audit confirmed that these deficiencies still have not been corrected.
- Although the Navy foots the bill for overtime costs on overhauls and conversions, it does not attempt to review the use of overtime or control it.
- There seems to be no effective system for independent Navy review of manpower requirements in relation to workload in the areas of direct and indirect labor.
- There is no effective system of internal audit by Electric Boat nor surveillance of this function by NAVSHIPS.
- The Navy still cannot get access to Electric Boat's financial books and records in areas of capital investment plans and cash flow.

Of course, the real test of the effectiveness of NAVSHIPS' corrective efforts at Electric Boat is the cost of doing work at the yard. In this regard, there is no sign of the improvements claimed by NAVSHIPS and Electric Boat. The company's most recent proposal for a conversion and overhaul contract--SSBN 656--indicates no significant change in cost from prior jobs.

5. Despite higher costs at Electric Boat, the Navy continues to pay Electric Boat substantially more fee than it pays Newport News for overhaul and conversion work. The practice of rewarding high costs with high profit, more than any other single factor, contributes to the high cost of overhaul and conversion work at Electric Boat and therefore must be remedied.

6. In summary, I recommend that NAVSHIPS:

a. Undertake, as a priority effort, the reduction of overhaul and conversion costs at Electric Boat by at least 30 percent to get them in line with costs for comparable work at Newport News. My past reports and the results of other follow-up reviews should serve as the basis for the needed improvements.

b. Establish closer Government surveillance of costs on submarine overhaul and conversion contracts at Electric Boat. This should include verifying Electric Boat budgets and costs for specific jobs against the cost of similar work at other shipyards.

c. Reduce the amount of fees paid to Electric Boat to bring them in line with what it would cost the Navy to get similar work done at Newport News.

7. I would appreciate being advised of what action NAVSHIPS intends to take in this matter.

H. G. Rickover
H. G. Rickover
Deputy Commander for
Nuclear Propulsion

Copy to:
Assistant Secretary of the Navy
  (Installations and Logistics)
Assistant Secretary of the Navy
  (Financial Management)
Chief of Naval Operations
Chief of Naval Material
Commander, Submarine Force Atlantic
NAVSHIPS 05
NAVSHIPS 04
NAVSHIPS 02
Supervisor of Shipbuilding, Groton, Connecticut

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6
UNITED STATES GOVERNMENT

Memorandum

425:WLB:klr
Ser: 1469-425

TO : SHIPS 08

DATE: 6 APR 1972

FROM : SHIPS 00

SUBJECT: Excessive Costs of Nuclear Submarine Overhaul and Conversion Contracts at Electric Boat

REFERENCE:
(a) NAVSHIPS Memo 08H-1495 of 18 SEP 1971
(b) NAVSHIPS Memo Ser: 368-022 of 23 MAR 1972
(c) NAVSHIPS Memo Ser: 369-022 of 22 MAR 1972
(d) SUPSHIP GROTON ltr to Mr. J. D. Pierce of 23 FEB 1972, Ser 100-67
(e) NAVSHIPS ltr to Mr. J. D. Pierce of 4 NOV 1971, Ser 4226-425
(f) NAVSHIPS ltr to Mr. J. D. Pierce of 27 MAR 1972, Ser 506-022D

1. In your memorandum of 18 September 1971, reference (a), you recommended that NAVSHIPS undertake an effort to reduce overhaul and conversion costs at Electric Boat by at least 30 percent, establish closer Government surveillance of costs on subject contracts and reduce the amount of fees paid to Electric Boat.

2. Several actions have been taken on this subject that include the areas noted above. A series of detailed studies has been completed by NAVSHIPS personnel which clearly indicate areas where costs are considered to be excessive at both Electric Boat and Newport News. The detailed reports, conclusions and recommendations resulting from these studies were provided by reference (b). I have approved the specific recommendations cited in the Task IV team report (enclosure (1) of reference (c)) and have directed that appropriate action be taken.

3. In addition to the action noted in paragraph 2 other actions pertinent to cost control at Electric Boat were taken by references (d), (e) and (f).

N. Sonenshein

Copy to:
SHIPS 02
04
05
425
425B2
425C2

5010-110
Buy U.S. Savings Bonds Regularly on the Payroll Savings Plan

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D C. 20360

IN REPLY REFER TO
08H-1496
2 Oct 1971

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS and LOGISTICS)

Subj: Progress Payments on Nuclear Shipbuilding Contracts

Ref: (a) VADM Rickover Memo of July 14, 1971 to ASN(I&L) on Excessive Progress Payments at Newport News Shipbuilding and Dry Dock Company
(b) ASN(I&L) Memo of August 23, 1971 to CNM, same subject
(c) ASN(I&L) Memo of August 23, 1971 to VADM Rickover, same subject

1. In reference (a) I pointed out that private shipbuilders are receiving more money through progress payments than they need to finance their Navy work; in effect, the Navy is providing these firms an interest-free advance of government funds. I suggested: (a) for future contracts, the Navy's policy should be changed so that progress payments are based on a contractor's actual cash outlays; (b) for current contracts, the Navy's procedures should be tightened to avoid overpayment.

2. In references (b) and (c) you concurred with my views and those of the Chief of Naval Material concerning the need for an in-depth review and revision of contract financing policies for future shipbuilding contracts. However, there was no guidance in your memoranda as to what action the Navy should take on existing contracts. It seems to me the Navy can and should also take immediate action to improve its administration of progress payments on existing contracts.

3. In reference (a) I cited several situations illustrating the problems in progress payment administration. One shipyard was billing the Navy for 100% of its subcontract costs, but was paying subcontractors progress payments at only a 90% rate. In addition, the yard was including in its billings the total cost of items that should have been capitalized over a multi-year period; and it was purchasing materials in greater quantities than necessary. Through these practices the company was able to accumulate a cash excess from progress payments which were greater than costs incurred. At the time of my report,

the single shipyard I cited had built up for itself a total of $9.2 million in interest-free government funds. I have no doubt that the Navy would find similar situations at other shipyards if an investigation were made.

4. Under current shipbuilding contract provisions, progress payments are calculated on the basis of Navy estimates of the physical progress of the ship under construction. There is evidence that the estimates are frequently influenced by extraneous considerations. In one case at Newport News Shipbuilding and Dry Dock Company, for example, the Navy made a special estimate of the progress made in a period covering the last three working days of 1970. This estimate showed progress on two ships during that period at 1.3% and .8% respectively; on this ground, Newport News received payments for the period totaling $1.5 million. The validity of this payment is questionable at best. It is remarkable in itself that anyone could evaluate three days' worth of progress on a 45-month shipbuilding contract; to measure that progress within a tenth of one percent is unbelieveable. Moreover, the estimated progress over these three working days was as great as the progress typically recorded over normal estimating periods, which cover a work span of 10 to 15 days. These facts indicate to me that in this case the estimate of physical progress was used as window dressing to support some predetermined rate of payment.

5. Many of our existing shipbuilding contracts still have years to run and would not be affected by the policy change you discussed in reference (b). Therefore, in addition to the policy direction you have provided for new contracts, I urge you to review and revise the Navy's administration of progress payments -- particularly the procedures for estimating physical completion -- on current contracts. We must eliminate the large overpayments being made to some shipbuilders under Navy contracts.

6. I would appreciate being informed of what action is taken in this regard.

H. G. Rickover

cc:
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D C 20350

26 October 1971

MEMORANDUM FOR VADM RICKOVER, USN, DEPUTY COMMANDER FOR NUCLEAR PROPULSION, NAVAL SHIP SYSTEMS COMMAND

Thank you for your memorandum of 2 October 1971 expressing further your views on the effect of current shipbuilding progress payment practices. Since my last memorandum to you concerning this matter I have continued to examine the question of shipbuilding financing in greater depth with respect to current and future shipbuilding programs. I recognize that substantial contractual commitments for new ship construction, including nuclear, have been made by the Navy in the last few years under current contract finance policies. I am also mindful of the fact that policy changes which might evolve from ASN(FM) reviews of present financing methods will require time to develop and effect.

I believe the question of shipbuilding financing is susceptible to both short and longer term considerations. From your memoranda of July and October I conclude that your examination of the effect of the Navy's current finance policies with respect to nuclear shipbuilding at the Newport News Shipbuilding and Dry Dock Company leads to your position that this shipbuilder has accumulated significant interest free Government funds. This is a matter I believe we can address in advance of longer term policy considerations and thereby accrue the benefits inherent in your examination of conditions obtaining at this Company.

Accordingly, by copy of this memorandum, I am requesting that the Chief of Naval Material promptly put into effect at Newport News Shipbuilding and Dry Dock Company the recommendations you have made in your memoranda of 14 July and 2 October 1971. I further desire that present contractual commitments with that Company be concurrently examined in the light of your findings and negotiations as necessary be opened with a view toward elimination of the conditions you cite. By interrelating negotiations for current proposed new construction with existing contracts it would appear that an optimum bargaining position could be achieved.

I am confident of your cooperation and assistance in this effort to obtain the more equitable and appropriate contract financing arrangements we both seek.

CHARLES L. ILL
ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS)

Copy to:
CNM,

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-1504
13 Oct 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Need for Improved Controls over Change Order Pricing at the General Dynamics Corporation's Electric Boat Division

Ref: (a) Deputy Commander for Nuclear Propulsion Memorandum to Commander, Naval Ship Systems Command, Ser 08H-1468 of 4 Jun 1971

1. By reference (a), I forwarded to you a memorandum from my field representative at Electric Boat Division, Groton which indicated that Electric Boat appeared to have overcharged the Government on a shipbuilding contract change by misrepresenting, during negotiation, the basis upon which the work would be performed.

2. In reference (a), I indicated that it appeared that NAVSHIPS should be entitled to a price reduction from Electric Boat on this particular change. Specifically, I recommended that NAVSHIPS take the following action:

a. Obtain an appropriate price reduction from Electric Boat for the change order in question on the basis that the information provided by Electric Boat during negotiations was not current, complete and accurate as required by the Truth-in-Negotiations Act.

b. Insist that major changes be handled under a cost separation shop order so that actual costs can be compared with negotiated prices for all significant changes.

c. Set up a system of spot checks to ensure that Electric Boat's pricing of proposals for changed work is in fact consistent with the way the work will be performed.

Also, I requested that I be advised of what action NAVSHIPS intended to take in this matter.

3. I have not yet received a response to reference (a). I would appreciate knowing what actions, if any, have been taken at Electric Boat in this matter.

H. G. Rickover

Copy to:
NAVSHIPS 02
NAVSHIPS 05

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-7550
15 Nov 1971

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Need for Improved Controls over Change Order Pricing at the General Dynamics Corporation's Electric Boat Division

Ref: (a) Deputy Commander for Nuclear Propulsion Memorandum, Ser 08H-1468 of 4 June 1971, same subject
(b) Deputy Commander for Nuclear Propulsion Memorandum, Ser 08H-1504 of 13 Oct 1971, same subject
(c) Commander, Naval Ship Systems Command Memorandum, Ser 280-0523 of 4 Nov 1971, same subject

1. In reference (a), I forwarded a memorandum from my field representative at Electric Boat Division, Groton which indicated that Electric Boat appeared to have overcharged the Government on a shipbuilding contract change by misrepresenting, during negotiations, the basis upon which the work would be performed. Reference (b) requested the status of what actions, if any, had been taken at Electric Boat in this matter.

2. Reference (c) states that you have directed SUPSHIPS, Groton to request DCAA to perform a review of the cost and pricing data upon which the negotiated price for the change was based and to audit the return costs of this change order. Reference (c) further states that upon receipt of the DCAA report NAVSHIPS should know the correct course of action in this matter. I would appreciate receiving a copy of the audit results.

3. With respect to the more general problems, reference (c) states that SUPSHIPS, Groton has increased the number of checks of actual progress on work ordered by changes and will conduct more frequent spot checks to compare the contractor's actual work performance with that proposed during change order negotiations. Moreover, according to reference (c), SUPSHIPS will require cost separation job orders more frequently on future change orders. I trust these added safeguards will also be implemented at all shipyards.

4. One further point should be clarified. Paragraph 3 of reference (c) states that I had authorized the change to be issued under a maximum price agreement and, had that course of action been followed, a better pricing action might have resulted. I consider that changes must be priced in advance of the work whenever possible. The problem in this case is that the change was overpriced because the contractor furnished erroneous data in support of his proposal. The incident highlights the need for better safeguards against overpricing -- not the need for more unadjudicated change orders.

5. I would appreciate being kept advised of progress in the matters discussed above.

H. G. Rickover
Deputy Commander for
Nuclear Propulsion

cc:
NAVSHIPS 02
NAVSHIPS 05

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
Ser 08-6817
14 December 1971

MEMORANDUM FOR THE COMMANDER NAVAL SHIP SYSTEMS COMMAND

Subj: Use of Overtime on Contracts for Overhaul or Conversion of Commissioned Nuclear Submarines in Private Shipyards, Recommendation to Reduce

1. During my visit to Ingalls Nuclear Shipbuilding on 11 December, the President of Ingalls stated, in response to my question, that the overall use of overtime in his yard averaged 2% to 3%, but that the overtime on nuclear submarine overhaul work in the yard was 14% to 15%. Similarly, my representative at Electric Boat has reported that the use of overtime on ships being overhauled in that yard far exceeds the rate of overtime used on new construction ships. It is obviously to the contractor's advantage to charge overtime to cost type overhaul contracts instead of fixed price type new construction contracts, since this results in greater profits and less cost risk to the contractor.

2. Subsequently, I learned that each current overhaul contract, as well as the proposal for the contract yet to be negotiated with Ingalls for the overhaul of USS GATO (SSN615), scheduled to commence in January 1972, contains an allowance for overtime premium pay of approximately 10%. I also note that current cost-plus-fixed-fee contracts covering the work done by private yards prior to ship arrival contain an allowance for overtime premium pay.

3. Since we do not have enough money to build the ships the Navy needs or even to repair those we have, and since costs are rising and productivity is poor, I consider the current excessive use of overtime, except for emergencies, unconscionable. This is particularly true when loafing at yards appears to be between thirty and fifty percent.

4. I recommend that you give this matter your personal attention and extricate NAVSHIPS from the absurd position of squandering our already limited resources on overtime. This is especially so when it is obvious that the use of overtime has, for many years, become a means for increasing pay, but with little or no productive benefit.

5. I would appreciate being advised of your action in the premises.

H. G. Rickover
H. G. RICKOVER

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
Ser 08N-2211
20 DEC 1971

From: Commander, Naval Ship Systems Command
To : DISTRIBUTION

Subj: Technical Documents and Design Data Furnished to Shipbuilders by Reactor Plant Prime Contracts and Reactor Plant Lead Yards for Ships Under Construction, Request to Specify Contractual Impact

Ref : (a) NAVSHIPS letter Ser 08M-1103 dated 15 July 1971 (NOTAL)

1. Reference (a) provides that design data furnished to shipbuilders by lead reactor plant design yards and reactor plant prime contractors for ships under construction are issued on the basis that no contract change is required. Reference (a) prescribes the procedure to follow and the notification to be made wherever the shipbuilder considers that such information requires a contract change. All nuclear qualified shipyards have acknowledged their acceptance of these arrangements.

2. Recently NAVSHIPS discovered that one shipbuilder was accepting technical information from a design agent on the basis that it might result in a contract change at some later time. Proper notification, as required by reference (a), was not provided. To avoid recurring problems in this area, reactor plant prime contractors and lead reactor plant design yards should include the following disclaimer in all future correspondence transmitting technical documents and design data in areas under the technical cognizance of NAVSHIPS (08) to shipbuilders for ships under construction.

> (Insert name or originator) does not have the authority to modify contracts between the shipbuilder and the government. Therefore if the action contained herein is considered by the shipbuilder to require a change in the currently negotiated price or amount or delivery or completion date of any contract, the shipbuilder shall not proceed with the action contained herein but should promptly, and in any event within 20 days of receipt of this document, notify NAVSHIPS (08) via the Supervisor of Shipbuilding of the facts and the reasons for considering that a contract change is required.

3. The action requested by this letter should be placed into effect upon receipt of this letter. Lead reactor plant design yards and reactor plant prime contractors are requested to confirm by 15 January 1972 that the actions requested by this letter are in effect.

4. The action requested by this letter is considered by NAVSHIPS to be within the scope of existing contracts, and no change in contract delivery or completion date or in the current negotiated price or amount of any government contract is authorized

H. G. Rickover
H.G. RICKOVER
Deputy Commander for
Nuclear Propulsion

DISTRIBUTION:
Electric Boat Division, General Dynamics Corporation,
    Groton, Via: SUPSHIP, Groton
Newport News Shipbuilding and Dry Dock Co.,
    Newport News, Via: SUPSHIP, Newport News
Electric Boat Division, General Dynamics Corp.,
    Quincy, Via: SUPSHIP, Quincy
PNRO
6NRO
ANSTR, MAO
ANSTR, PAD

Copy to:
PNRO Rep., Groton (2)
PNRO Rep., Pascagoula
PNRO Rep., Newport News
General Manager, Bettis
General Manager, KAPL
General Manager, MAO
General Manager, PAD
Ingalls Shipbuilding Corp., Pascagoula
    Via: SUPSHIP, Pascagoula

NEWPORT NEWS SHIPBUILDING
AND DRY DOCK COMPANY
A Major Component of Tenneco Inc.
NEWPORT NEWS, VIRGINIA 23607 • PHONE 703-247-1211

General/Contracts

January 17, 1972

RADM C. M. Hart
Supervisor of Shipbuilding,
Conversion and Repair, U. S. Navy
Newport News Shipbuilding and Dry Dock Company
Newport News, Virginia 23607

Subject: Technical Documents and Design Data Furnished to Shipbuilders by Reactor Plant Prime Contractor and Reactor Plant Lead Yards for Ships Under Construction

References:
(a) SupShip-NN letter Gen/4330, Ser 415-481 dated 29 December 1971
(b) NAVSHIPS letter 08N-2210 dated 20 December 1971

Dear Sir:

Reference (a) stated that a Disclaimer Clause, as provided in reference (b), should appear on all future correspondence transmitting technical documents and design data under the cognizance of NAVSHIPS (08). Reference (a) further requested confirmation by January 15, 1972 that the actions required by reference (b) are in effect.

This letter is to confirm that we have implemented the requirements of reference (b), effective this date, for all work performed by us as a Lea Reactor Plant Design Yard and for all work performed by us which is equivalent to a Lead Reactor Plant Design Yard and/or a Reactor Plant Prime Contra

Yours very truly,

C. E. Dart
C. E. Dart
Vice President

CLW:vep
One duplicate herewith

GENERAL DYNAMICS
Electric Boat Division
Eastern Point Road, Groton, Connecticut 06340 • 203 446 1950

February 2, 1972

Subject: Technical Documents and Design Data Furnished to Shipbuilders by Reactor Plant Prime Contracts and Reactor Plant Lead Yards for Ships Under Construction

Reference: (a) SUPSHIP-Groton ltr Ser: 400-1C dtd 4 January 1972 endorsing NAVSHIPS ltr Ser: 08H-2211 dtd 20 December 1971

Vice Admiral H. G. Rickover, USN
NAVSHIPS 08
Naval Ships Systems Command Headquarters
Navy Department
Washington, D. C. 20360

Via: Supervisor of Shipbuilding
Conversion and Repair, USN
Groton, Connecticut 06340

SIR:

1. Reference (a) requested Electric Boat Division, as a lead reactor plant design yard, to incorporate a disclaimer on all future correspondence transmitting technical documents and design data in areas under the technical cognizance of NAVSHIPS 08 to shipbuilders for ships under construction. This disclaimer is to assure that the information transmitted is issued on the basis that no contract change be required.

2. Electric Boat Division has taken action to place the use of the disclaimer into effect. Since it will be necessary to obtain stamps and revise procedures, full compliance will be achieved by February 15, 1972.

Very truly yours,

J. D. Pierce

J. D. Pierce
General Manager

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

2 8 DEC 1971

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subject: Litton Industries Management of Navy Shipbuilding Work at the Ingalls Nuclear Shipbuilding Division (East Bank) and Ship Systems Division (West Bank) Pascagoula, Mississippi

1. In a telephone conversation last night you advised me of a suggestion within the Government that Litton Industries be encouraged to consolidate work at its Ingalls Nuclear Shipbuilding Division (East Bank Yard) and its Ship Systems Division (West Bank Yard), Pascagoula, Mississippi, under the management of the East Bank yard. As I understand the suggestion, Litton would use key management and shipbuilding trades personnel interchangeably between these yards as necessary to carry out the West Bank yard commitments under the LHA and DD 963 programs. In effect, the East Bank yard would become responsible for that work.

2. In our discussion I told you I opposed this suggestion. My experience in the nuclear submarine program is that the management talent and the availability of skilled, qualified trades personnel at the East Bank yard is limited — barely able to cope with its own problems. The problems that exist on current submarine contracts indicate that there is no excess talent from nuclear submarine work to solve problems at the West Bank yard. For example:

a. Construction of SSN's 680, 682 and 683 is behind original schedules and the performance of work is unsatisfactory in many respects. Poor workmanship on the reactor plant is resulting in costly and time consuming ripout and rework. The manager of the East Bank yard has been giving these problems much of his personal attention; he must continue to do so if these ships are to be completed in a reasonable time.

b. Litton has been endeavoring to establish a nuclear submarine overhaul and refueling capability at the East Bank yard for many years. Progress has been slow. The delays in establishing a refueling capability recently forced the Navy to reassign the overhaul and refueling of the USS DACE (SSN 607) from Litton to another shipyard. The establishment of a nuclear ship overhaul and refueling capability at the East Bank yard is another substantial effort that will require a great deal of management effort and utilization of key trades personnel at the East Bank yard.

3. If the Navy permits or requires diversion of key nuclear resources at the East Bank yard to support the LHA and DD 963 programs at the West Bank yard, it will undo the nuclear capability for which the Navy has worked so long and at great expense to create.

4. If the Navy seriously pursues the suggestion to utilize the East Bank yard to support the LHA and DD 963 programs, I recommend that we immediately stop all actions to establish a nuclear refueling capability at the East Bank yard. If the situation further developes that there is insufficient talent at the East Bank yard to perform the nuclear work now underway, I would be compelled to consider withdrawing its qualifications as a nuclear yard. In this event I would recommend that we initiate action to complete construction of SSN's 680, 683 and 686 now at the East Bank yard at one of the other nuclear qualified private yards.

5. Litton presently has unsettled contract changes and outstanding claims against the Government which total well over $250 million. If the Navy requires a change in management in the Litton organization, the Navy will thereby assume a large degree of responsibility for the work and expose itself to substantial risks of further contract claims by Litton. The Navy could well become liable for future delays and difficulties at both shipyards, particularly for any deterioration in performance.

6. For the above reasons I recommend against the suggestion to consolidate responsibility for work at the East and West Bank yards. Litton and the Navy contracted for the LHA and DD 963 programs with full knowledge of the problems inherent in starting a new yard and utilizing new approaches to shipbuilding. It would be wrong to attempt a possible solution to these problems at the expense of our nuclear submarine programs.

H. G. Rickover
H. G. Rickover

Copy to:
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-502
19 Jan 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Review of Procurement and Cost Control Systems at the Electric Boat Division of General Dynamics Corporation

Ref:
(a) My memorandum dtd 13 Sep 1969 to ASN(I&L)
(b) NAVSHIPS memo OON:FCJ:lt Ser 124-OON dtd 30 Apr 1970
(c) My memorandum Ser 08H-772 dtd 26 Aug 1970 to ASN(I&L)
(d) NAVSHIPS ltr OON:FCJ:lt Ser 468-OON dtd 23 Dec 1971

Encl:
(1) List of my reports of deficiencies at the Electric Boat Division of General Dynamics Corporation
(2) Minutes of 9 December 1971 meeting between SUPSHIPS, Groton, and NAVSHIPS 08 Representatives, Groton

1. In reference (a), I reported deficiencies in the procurement and cost control systems under Navy contracts at the Electric Boat Division of General Dynamics Corporation. Reference (b) is the report of a Special Navy Review Team formed to investigate those deficiencies. Reference (c) contains my comments on the shortcomings of the review team's report.

2. Reference (d) requested a follow-up review of the procurement and cost control systems at Electric Boat by the Naval Ship Systems Command Inspector General. He asked me to make recommendations for such a review.

3. Enclosure (1) lists several reports I have made concerning other deficiencies at Electric Boat since the Special Navy Review Team visited the shipyard. My representatives at Electric Boat recently asked the Supervisor of Shipbuilding what action had been taken on the recommendations contained in my reports. Enclosure (2) is the Supervisor's response. It shows that not much has been done to correct the basic deficiencies I have reported.

4. If there is to be a follow-up review, my reports would be a good starting point. In my opinion, however, the Navy has already wasted far too much effort in reviews. In the past three years the Navy has had team after team, group after group travel to shipyards to review the same deficiencies. These have resulted in considerable effort but few tangible results. What is needed is corrective action.

5. My recommendation is that, instead of devoting effort to yet another review, NAVSHIPS concentrate on solving the long-standing problems which have already been identified.

H. G. Rickover

Copy to:
NAVSHIPS OON
02
05

List of VADM Rickover Reports of Deficiencies at the Electric Boat Division of General Dynamics Corporation

- VADM Rickover memorandum Ser 08H-767 dtd 15 Jul 1970 to ASN(I&L) Subj: Review of Overhead Costs on Navy Contracts at Electric Boat
- VADM Rickover memorandum Ser 08H-786 dtd 30 Oct 1970 to ASN(I&L) Subj: Excessive Shipbuilder Profits on Nuclear Submarine Overhaul and Conversion Contracts
- VADM Rickover memorandum Ser 08H-1468 dtd 4 Jun 1971 to COMNAVSHIPS Subj: Need for Improved Controls over Change Order Pricing at the General Dynamics Corporation's Electric Boat Division
- VADM Rickover memorandum Ser 08H-1494 dtd 11 Sep 1971 to COMNAVSHIPS Subj: Employment of Electric Boat Personnel by the Supervisor of Shipbuilding, Groton, Connecticut
- VADM Rickover memorandum Ser 08H-1495 dtd 18 Sep 1971 to COMNAVSHIPS Subj: Excessive Costs of Nuclear Submarine Overhaul and Conversion Contracts at Electric Boat

PURPOSE OF MEETING: This meeting was held so that SUPSHIP, Groton could identify what action has been taken to improve the administration of Navy contracts at Electric Boat, particularly with respect to problems raised in various NAVSHIPS 08 memoranda. It is understood that the reporting of this information does not in any way relieve SUPSHIPS, Groton from its responsibility to take appropriate corrective action, nor does this meeting constitute NAVSHIPS 08, Naval Reactors or NR Rep, Groton concurrence, either expressed or implied, with the actions outlined by SUPSHIPS.

ATTENDEES: SUPSHIPS, Groton

CAPT A. E. Rose, Jr., SUPSHIPS, Groton
CDR V. J. Manara, Jr., Deputy SUPSHIPS
CDR M. MacKinnon, III, Quality Control and Engineering Officer
CDR R. R. Taylor, Contracting Officer

NR Rep., Groton

E. J. Siskin
D. E. Ledwig

DATE OF MEETING: Thursday, December 9, 1971

I. GENERAL

CAPT Rose started with a discussion of various actions he is taking to improve the operation and effectiveness of SUPSHIPS, Groton. He pointed out that many of these actions were being taken on his own initiative and without any impetus from NAVSHIPS 08. CAPT Rose stated that these actions include:

A. CAPT Rose has been conducting a program to meet with every SUPSHIPS, Groton supervisor. This program is now nearly completed. The key points he discusses are: (1) the changing contract environment, resulting in a shift from fixed-price contracts to cost sharing type contracts; (2) the need to develop improved methods of cost control and cost reductions; (3) the standards of conduct expected of SUPSHIPS, Groton employees; (4) SUPSHIPS, Groton employees must feel responsible for their jobs and for a satisfactory product. He also solicits any suggestions they may have for improving the effectiveness of SUPSHIPS, Groton.

B. SUPSHIPS, Groton has started conducting reviews of various general work areas to determine what problems exist. The first area investigated was valve overhaul work. A number of deficiencies including lack of cost feedback, poor shop procedures and planning and poor productivity were identified and have been raised with EB in a formal letter from Rose to Pierce. No answer has been received yet. The current area being investigated is operation of the machine shop. The next plan review will be in the area of preservation and protection of equipment.

C. A group headed by CDR Ballantine (SUPSHIPS Planning and Estimating Officer) is comparing overhaul work authorization systems at SUPSHIP, Groton and Electric Boat with Newport News to determine ways to reduce costs and improve control. Ballantine will also compare productivity at Newport News with that at EB to determine where improvements can be made.

D. SUPSHIPS now has routine monthly meetings with the local Defense Contract Audit Agency (DCAA) office to coordinate what areas will be checked both by DCAA and SUPSHIPS.

E. SUPSHIPS is taking the lead with NAVSHIPS in preparation of a manual for the control of operations relating to watertight integrity (SUBLANT and Norfolk Naval Shipyard are also participating). This manual will also establish standard requirements for launching and undocking a ship. This manual should be issued within about six months.

F. SUPSHIPS and DCAA performed a detailed study of EB's material control and handling, from initial procurement until final salvage, which identified a large number of deficiencies. This was probably the "straw that broke the camel's back" resulting in EB's making massive changes in this area. This review was initiated in July 1971. A draft report was issued to Electric Boat and EB's initial response has been received and is being reviewed by SUPSHIPS.

G. SUPSHIPS has just hired an industrial engineer with cost and quality control backgrounds. He will be assigned to work for the SUPSHIPS business analyst (Sykora). The first area he plans to investigate is excessive maintenance costs. Ledwig noted that an EB hired consulting firm, WOFAC, has done work in this area. Rose indicated that he expected he would be able to get copies of this report, or any other, from EB.

H. Rose has sent a letter to Pierce raising the issue of the high EB cost of overhauls in comparison with Newport News. Pierce has not yet replied formally to this specific letter. This letter pre-dates a letter from Admiral Sonenshein to Pierce on this same subject.

I. Rose has requested NAVSHIPS help in investigating possible excess costs in the employee compensation areas such as those resulting from trade union practices. He pointed out that these areas are very sensitive and that only highly experienced personnel should be permitted to investigate them. An example of the kind of excess about which he is concerned is the EB labor contract requirement that carpenters be available to install or remove brows any time a ship is moved. This is in addition to the normal riggers required.

J. SUPSHIPS, Groton personnel are participating in NAVSHIPS task forces investigating: (1) any differences between the work authorized and work actually accomplished at both Electric Boat and Newport News. This review is being conducted in considerable detail, including visits to SSBN-634 (overhauled at Electric Boat) and SSBN-636 (overhauled at Newport News); (2) overhaul cost comparisons between Electric Boat and Newport News in the areas of material control, direct labor hours and overhead comparability.

K. SUPSHIPS is working with EB to develop a more efficient means of defining and negotiating emergent overhaul work items.

L. SUPSHIPS is working with NAVSHIPS to develop action plans covering corrective action for all problem areas identified in the "Jones Report". These action plans will be available by the end of January 1972. These action plans are being established for EB, Newport News and Ingalls and are part of NAVSHIPS Contract Administration Improvement Program (CAIP).

QUALITY CONTROL

CAPT Rose stated that action being taken by SUPSHIPS, Groton in the specific areas discussed in Admiral Rickover's memorandum to Admiral Sonenshein dated September 1, 1971, include the following:

A. SUPSHIPS Organization - SUPSHIPS has implemented a reorganization, approved by NAVSHIPS for a one-year trial period, in which quality control and engineering functions report to CDR MacKinnon (Quality Control and Engineering Officer). Quality control was previously associated with the production management function. CAPT Rose indicated that this reorganization is proving very beneficial since close coordination between these two groups (Engineering and Quality Assurance) results in more effective quality control and in prompt resolution of quality rejections. No conflict of interest exists since neither engineering nor quality control has responsibility for production. CDR MacKinnon noted that he is spending a greater share of his time in the quality control area at this time.

Rose indicated that he hopes that NAVSHIPS will permit a full one-year trial of this reorganization.

B. Surveillance of Non-Destructive Testing - SUPSHIPS now actually conducts liquid penetrant inspections of joints previously accepted by EB Quality Control. During the first weekend in December 1971, SUPSHIPS inspectors actually performed liquid penetrant inspections of sixteen joints. All were satisfactory. These inspections will continue. In addition, SUPSHIPS will ask EB to reinspect, under SUPSHIPS observation, about five previously accepted joints per week. Further visual inspections to NAVSHIPS 250-1500-1 requirements will also be accomplished. SUPSHIPS has been reviewing other non-destructive testing areas to determine where else actual government inspections would be of value.

Regarding radiography film reviews, SUPSHIPS no longer will advise EB of the scope of their surveillances.

SUPSHIPS is taking action to formally qualify their non-destructive testing inspectors in their areas of responsibility. The present status is:

1. Liquid Penetrant - The Branch Head is a qualified NAVSHIPS 250-1500-1 examiner and has qualified five inspectors.

2. Radiography - One qualified examiner and three qualified readers.

3. Magnetic Particle - A SUPSHIPS Quality Control employee will take the Magnetic Particle Examiner's Test at Bettis during the week of December 13, 1971.

4. Ultrasonic - A SUPSHIPS employee will be sent to Bettis in mid-January 1972 in order to qualify as an examiner.

C. Inspection Coverage of Back-Shifts and Weekends - Two to three SUPSHIPS inspectors are being assigned to second-shifts and weekends. The emphasis is on in-process work. During November, the addition of one more man to off-shifts accounted for approximately 2,000 additional observations in the nuclear area. No discrepancies were noted. A system is being established to identify when work will be conducted on back-shifts which would warrant SUPSHIPS surveillance.

D. Training and Qualification of SUPSHIPS Inspectors - SUPSHIPS is developing a formal qualification program. Training in local nuclear standard instructions and standard documents is expected to be completed by March 1972. In addition, approximately 35 SUPSHIPS inspectors will be qualified to Nuclear Welding Standard (NAVSHIPS 250-1500-1) visual inspection requirements.

NAVSHIPS is also working on a formal training program. Programs, including outside training, are being established in shielding, lifting, cleaning, marking, material control and non-destructive testing. SUPSHIPS, Groton has the lead for preparing programs in the shielding, lifting areas and NDT areas.

E. Inspecting to Proper Standards - SUPSHIPS is reviewing attribute check lists to insure that these lists meet the requirements of NAVSHIPS 250-1500-1 and that all important parameters are covered.

F. Further Comments Regarding Quality Control

1. SUPSHIPS plans to establish a nuclear inspection group with a supervisor and three to five inspectors. These inspectors will undergo a formal

training and qualification program, although the specific details have not yet been established. The supervisor will have complete shift freedom to cover any areas of concern.

2. To ensure that identified problems are raised to the proper level of EB management, the new nuclear inspection group will have the authority to deal with EB management reporting to the General Manager. Siskin pointed out that it is necessary to review the discrepancies found in order to be in a position to raise such issues with EB management. For example, of 80 quality efficiency reports issued by SUPSHIPS so far this year, more than 20 concerned receipt inspection marking deficiencies. Yet SUPSHIPS has not raised this general issue with EB management.

3. To permit ready identification of SUPSHIPS inspectors on the waterfront, all SUPSHIPS inspectors will wear hard hats painted international orange.

4. CDR MacKinnon noted that one aspect of SUPSHIPS quality control being investigated is whether their people are "mesmerized" by statistics. MacKinnon is devoting much of his time to overcome this attitude and to developing a balance between the analysis of statistical sampling and actual observations of hardware for the purpose of assuring contractor quality.

FISCAL MATTERS

SUPSHIP actions taken in response to recommendations of VADM Rickover for corrective action at Electric Boat.

G. Recommendations to the Assistant Secretary of the Navy (I&L) Dated 13 September 1969 and SUPSHIP's Response.

1. Recommendation: Withdraw Navy approval of the procurement system. The company should be required to submit all proposed subcontracts in excess of $25,000 for Government review and approval prior to placement.

SUPSHIP's Response: Electric Boat's procurement system approval has been allowed to lapse. To date NAVSHIPS reapproval has not been granted. Two annual procurement reviews have been performed since, and improvements have been noted. SUPSHIP has employed a Procurement Methods Analyst to review EB's procurement full time. Effort will be directed toward improving the quality of EBDIV cost and price analysis. This is an area in which SUPSHIP considers EBDIV procurement to be deficient.

2. Recommendation: Withdraw approval of Electric Boat's accounting system until effective controls are established to preclude mischarging of labor and material costs on Government contracts.

SUPSHIP's Response: Recent labor audits reveal great improvement in the accuracy of labor charges from a sampled error rate of 32% in early 1970 to less than 1% now. However, SUPSHIP and the DCAA have identified numerous deficiencies in EB's material control system which have been taken up with EB Management over the past six months. EB has acknowledged that deficiencies exist and will report to the Supervisor what corrective action they are taking in January 1972. SUPSHIP and DCAA will continue to investigate EBDIV's accounting system and will require corrective action where necessary.

3. Recommendation: Revise progress payment procedures so that General Dynamics no longer gets interest-free use of Government funds.

SUPSHIP's Response: This recommendation, with regard to new construction contracts, is being reviewed by a special Navy progress payments review team composed of NAVSHIPS, NAVCOMPT, and NAVMAT members. In addition, a new payments clause for cost-type contracts has been issued effective 1 January 1972. This clause will restrict reimbursement to actual cash payments made by the contractor. It is understood that NAVSHIPS will issue instructions restricting payments on cost-type contracts.

4. ISSUE: Ledwig asked what action was being taken concerning the following related statement in the 13 September 1969 NAVSHIPS 08 report:

> "Through questionable material charging practices, Electric Boat is charging the government for material that remains in inventory."

Ledwig pointed out Electric Boat is doing this in order to collect a progress payment in advance of material actually being issued. Ledwig stated NAVSHIPS 08 pointed out to the Assistant Secretary of the Navy (I&L) on 26 August 1970 that:

> "Thus even assuming the Government were willing to allow Electric Boat to obtain progress payments on its inventories, it does not appear that the Government determination required by ASPR B-303(e) has been made, nor that Electric Boat's accounting for materials is adequate to comply with the conditions cited in ASPR B-312."

SUPSHIP's Response: Two separate issues are involved here. The first issue is whether or not material costs can be properly allocated to contracts prior to physical movement of the material to the waterfront. The second problem concerns the ability of the EBDIV property control system to adequately protect our interests as specified in ASPR B-312. It is the opinion of the Supervisor and DCAA that the method of allocation currently employed by EBDIV on cost-type contracts is allowable under the terms of current contracts. While we agree that it would be advantageous from several aspects to require EBDIV to totally fund the inventory, current ASPR cost principles allow otherwise. In early January 1972 EBDIV will brief the Supervisor concerning the changes to his material control system. If his new system meets ASPR requirements, the determination required by ASPR B-303(e) will be made. If not, DCAA will be instructed to recommend appropriate disallowances.

5. Recommendation: Issue instructions to preclude the Government from financing development of the Artic submarine tanker and other commercial ventures.

SUPSHIP's Response: The DCAA is preparing a suspension in the amount of $612,375. This recommended disallowance is now being reviewed by DCAA Regional Office and will be forwarded to SUPSHIP in the near future. It is interesting to note that EBDIV is currently charging this expense to Corporate IR&D.

6. Recommendation: Issue policy instructions to preclude employment of former contractor personnel in positions where they are responsible for reviewing contractor operations in the activity where they were formerly employed.

SUPSHIP's Response: This is a matter for NAVSHIPS action. No policy instructions have been issued by SUPSHIP in this area.

7. Recommendation: Require that the decision as to whether work should be performed in-house or subcontracted (make or buy) as well as the decision to assign work to other General Dynamics divisions be reviewed and approved in advance by the Government.

SUPSHIP's Response: Advance reviewed of make-or-buy decisions are performed by SUPSHIP on long lead time material contracts. SUPSHIP does not participate in make-or-buy decisions on other contracts but reviews the contractor's policies and procedures as part of the continuous surveillance of contractor's procurement system; additionally minutes of the EBDIV Make-or-Buy Committee are reviewed on an after-the-fact basis.

8. Recommendation: Establish principles, procedures and the means to place the Government on an equal footing with the contractor in settling change orders and claims.

SUPSHIP's Response: Efforts to improve the quality of SUPSHIP's contracts personnel are being made. Formal training in Cost Principles, negotiation and contract administration is being provided at both Government as well as commercial activities. Hiring practices geared to selecting the "best qualified" individual are being pursued for all positions where the Civil Service rules permit. The staff of the Contracts Department now has three MBA's, a law degree and a number of individuals with undergraduate degrees. Also, Counsel is assigned to SUPSHIP to advise the Contracts Department on disputed items. Adequate technical support personnel have been made available to the contracts area. "Equal footing" philosphy with the contractor is being constantly emphasized by the management of the Contracts Department. The management will continue to intensify the efforts to improve the quality and quantity of work in the contracts area. To that objective, plans have been made to request the hiring of two new young and aggressive graduates for claims work. Additionally, a five-year manpower development program has been undertaken to provide orderly replacements with fully qualified individuals as the vacancies through retirement are created.

9. Recommendation: Assign a team of experienced procurement and cost control specialists to conduct a thorough investigation of procurement and cost control practices and to develop a comprehensive corrective action program so as to preclude further waste of Government funds.

SUPSHIP's Response: Numerous NAVSHIPS investigators have visited EBDIV to study overhaul costs. In addition, the Resident Government Auditor is now reviewing the EBDIV procurement area. SUPSHIP has employed a full-time procurement analyst. Electric Boat has employed a consulting firm to increase productivity and set new production standards.

H. Recommendations to the Assistant Secretary of the Navy (I&L) Dated 15 July 1970 and SUPSHIP's Response.

1. Recommendation: The Navy should require Electric Boat to establish definitive standards and criteria for charging costs directly to contracts or to overhead.

SUPSHIP's Response: The Resident Government Auditor still has problems in this area. SUPSHIP expects that Uniform Cost Accounting Standards might help correct the problem.

2. Recommendation: The Navy should insist that Electric Boat's accounting system be adequate to ensure that costs are charged fairly between cost-type and fixed price contracts.

SUPSHIP's Response: There have been several improvements in this area; however, SUPSHIP still finds problems which have been and will continue to be taken up with Electric Boat Management as they are identified.

3. Recommendation: The Navy should establish a formal program for regular review and appraisal of the efficiency and effectiveness of each overhead function.

SUPSHIP's Response: SUPSHIP recognizes the need for a comprehensive review of EBDIV overhead. NAVSHIPS is looking at this recommendation and plans action. If NAVSHIPS does not take action soon, a positive program will be developed by SUPSHIP.

4. Recommendation: The Navy should require a "lease versus purchase" analysis of any facilities items which will be charged directly or indirectly to Government contracts.

SUPSHIP's Response: This is not being required of Electric Boat by SUPSHIP except in the ADPE area or where specifically required by ASPR or the contract. An ADPE request has been submitted for approval. This proposal is currently under study.

5. Recommendation: The Navy should establish procedures for the review and analysis of Electric Boat manpower requirements in order to ensure that Electric Boat does not carry excessive personnel at Government expense.

SUPSHIP's Response: NAVSHIPS 425.B2 (Blaney) is reviewing this area as part of an overhaul work comparison between Electric Boat and Newport News.

6. Recommendation: The Navy should require Electric Boat to obtain the maximum possible competition for overhead purchases, including purchases of insurance and other service costs. Government approval of sole source procurement should be required for purchases of $25,000 or more.

SUPSHIP's Response: Current Navy directives require all insurance matters to be forwarded to NAVMAT for action. In other areas, two actions have been taken. An industrial engineer will investigate EBDIV's maintenance program and other high cost areas. Secondly, we are arranging with DCASR (Boston) to perform a compensation schedule review which will include hourly, salaried, and other aspects of compensation including bonuses.

I. Recommendations to COMNAVSHIPS Dated 4 June 1971 and SUPSHIP's Response.

1. Recommendation: Insist that major changes be handled under a cost separation shop order so that actual costs can be compared with negotiated prices for all significant changes.

SUPSHIP's Response: This is not done in all cases but SUPSHIP has taken this action for a number of recent changes. Some changes are too broad in scope to permit valid cost separation. An audit check has been performed on a recent change under which costs were segregated and the results are inconclusive. Much effort remains to be done in this area.

2. Recommendation: Set up a system of spot checks to ensure that Electric Boat's pricing of proposals for changed work is in fact consistent with the way the work will be performed.

SUPSHIP's Response: No formal system of spot checks has been set up.

J. Recommendation to COMNAVSHIPS Dated 11 September 1971 and SUPSHIP's Response.

1. Recommendation: I recommend that NAVSHIPS adopt a policy of not hiring contractor personnel for positions involving contract administration and Government surveillance at activities where they were formerly employed.

SUPSHIP's Response: This is a matter for NAVSHIPS.

K. Recommendations to COMNAVSHIPS Dated 18 September 1971 and SUPSHIP's Response.

1. Recommendation: Undertake, as a priority effort, the reduction of overhaul and conversion costs at Electric Boat by at least 30 percent to get them in line with costs for comparable work at Newport News. My past reports and the results of other follow-up reviews should serve as the basis for the needed improvements.

SUPSHIP's Response: Two NAVSHIPS groups from SHIPS 04 (Blaney) and SHIPS 05 (Ferguson) are now looking into this matter. A SUPSHIP team also is comparing EBDIV and Newport News work packages.

2. Recommendation: Establish closer Government surveillance of costs on submarine overhaul and conversion contracts at Electric Boat. This should include verifying Electric Boat budgets and costs for specific jobs against the cost of similar work at other shipyards.

SUPSHIP's Response: NAVSHIPS 04 (Blaney) is looking into this matter. SUPSHIP personnel are participating in the effort. The SUPSHIP Work Planning Officer recently spent a week at Newport News observing operations there for possible cost savings ideas.

Additional Issues Raised with COMNAVSHIPS on 18 September 1971 and SUPSHIP's Response.

3. Issue: Electric Boat has announced some planned facility improvement projects. Most of these projects are aimed at improving productivity and efficiency on fixed price, new construction work where Electric Boat must be competitive to continue to get business. Not much seems to be planned to improve overhaul facilities where work is done on cost-type contracts. To my knowledge, the Navy has not obtained a commitment from Electric Boat to improve the facilities being used on cost-type overhaul and conversion work.

SUPSHIP's Response: The Supervisor has seen Electric Boat's five-year capital improvement plan which includes facilities for ULMS and 688 Class submarines. SUPSHIP has received no commitments from Electric Boat to improve their overhaul facilities.

4. Issue: Although the Navy foots the bill for overtime costs on overhauls and conversions, it does not attempt to review the use of overtime or control it.

SUPSHIP's Response: NAVSHIPS contracts do not require review of overtime. However, SUPSHIP agrees overtime should be monitored and plans to set up a system to review this area. Additionally, NAVSHIPS has been requested to require SUPSHIP's approval of overtime premiums on the next CPFF contract.

5. Issue: It costs about twice as much to dry dock a submarine at Electric Boat as it costs to dry dock one at Newport News. Yet, no one seems to be working with Electric Boat to try to lower costs in this area.

SUPSHIP's Response: SUPSHIP now is reviewing this matter.

6. Issue: The Navy still cannot get access to Electric Boat's financial books and records in areas of capital investment plans and cash flow.

SUPSHIP's Response: This area has improved but the problem is not solved. SUPSHIP has been successful in obtaining access to certain records on a case-by-case basis.

7. Issue: There is no effective system of internal audit by Electric Boat nor surveillance of this function by NAVSHIPS.

SUPSHIP's Response: This is correct. Electric Boat will not give SUPSHIP access to their internal audit plans. This issue is still being pursued with Electric Boat.

SUPSHIPS, Groton

Albert E Rose Jr.
ALBERT E. ROSE, JR.
CAPTAIN, USN

NR Rep, Groton

EDWARD J. SISKIN

Donald E. Ledwig
DONALD E. LEDWIG

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-512

7 Feb 1972

The Honorable William Proxmire
U. S. Senate
Washington, D. C.

Dear Senator Proxmire,

Your letter of November 29, 1971, requested my comments on a Naval Ship Systems Command letter dated November 5, 1971. That letter discussed the large disparity in costs incurred and profits paid on nuclear submarine overhaul and conversion work at two major shipyards.

I explained this issue in testimony before your Joint Economic Committee on April 28, 1971. The basic issue is straightforward. I testified as follows:

> The Defense Department's current profit policies reward inefficiency. Under today's defense procurement regulations, the higher the costs on a defense contract, the higher the profit. Contractors have no incentive to invest in new machine tools or other facilities which could make defense work more efficient. There is instead a strong incentive for a contractor to maintain minimum investment with the highest possible cost base for determining profit.
>
> Last year I reported to my superiors a specific example of the inequities of the present practice of figuring profits as a percentage of costs. Two contractors were each awarded noncompetitive contracts for the same kind of job. Contractor A's costs were $26 million - 45 percent - higher than Contractor B's for a comparable scope of work. Yet Contractor A was paid $1.4 million more profit than Contractor B. The contractor with the higher costs was awarded a higher profit than the more efficient contractor.

In subsequent hearings held by your committee on September 28, 1971, you asked the Commander, Naval Ship Systems Command to advise you what action the Navy has taken to correct this situation. His response is contained in his November 5th letter. In general, it implies that corrective action has been taken and that substantial improvements have been made. I regret to advise you that, in my opinion, this is not the case.

My comments on the Navy response are attached as enclosure (1). I invite your attention particularly to Tables 1 and 2 of the enclosure.

I trust that my comments are responsive to your request.

Respectfully,

H. G. Rickover

H. G. Rickover

Enclosure (1): VADM H. G. Rickover comments on NAVSHIPS letter dated November 5, 1971

Copy to:
Assistant Secretary of the Navy
(Installations & Logistics)
Chief of Naval Material
Commander, Naval Ship Systems Command
Office of Legislative Affairs

Detailed Comments on NAVSHIPS letter dated November 5, 1971

A. NAVSHIPS Statement:

> In viewing the problem of apparent inequity between Polaris/Poseidon overhaul and conversion costs and fees at (Shipyard A) and (Shipyard B), it must be recognized that we are dealing with one of the most complex weapons systems ever developed, a process involving imprecise initial estimates (overhaul and repair), and an extremely complex industrial environment. As a consequence, it is a most difficult task to compare the operational and control procedures as well as the end product of these two shipbuilders. In addition, our efforts are significantly limited by the lack of direct comparability between their respective accounting systems.

Admiral Rickover Comment:

One reason it is difficult to make detailed comparisons of the costs of individual tasks at these two yards is that the Navy has not established minimum standards for accounting and reporting of costs under ship overhaul contracts. The shipyards may keep their books almost any way they please -- even though, under their contracts, their accounting systems are supposed to be satisfactory to the Navy. The results in total, however, can be compared.

Table 1, on the following page, shows that the negotiated target costs at Shipyard A for nine overhaul and conversion jobs involving essentially the same work were about $60 million higher than for Shipyard B; for this higher cost, the Navy allowed Shipyard A $5.4 million more profit than Shipyard B.

TABLE 1

PREMIUM IN TARGET COST AND TARGET FEE FOR WORK PERFORMED AT SHIPYARD A RATHER THAN SHIPYARD B

	Average Per Ship	
	Target Cost	Target Fee
Shipyard A	$28.2 Million	$2.7 Million
(-) Shipyard B	21.6	2.1
Average premium per ship	$ 6.6 Million	$ .6 Million
Number of ships handled by Shipyard A	x9	x9
Total premium for work performed at Shipyard A rather than Shipyard B	$59.4 Million	$5.4 Million

B. NAVSHIPS Statement:

The problem is further aggravated by the fact that these companies are operating in very different business environments, a situation which definitely impacts their respective cost profiles. (Shipyard A) is solely a submarine overhaul and construction operation, whereas (Shipyard B) is involved in a variety of naval shipbuilding and devotes approximately 10% of its effort to various types of commercial work. At the present time, (Shipyard A) is cutting back its labor force because of lack of scheduled work, while (Shipyard B) is significantly increasing its force. Both of these situations afford (Shipyard B) a broader industrial base over which to spread its indirect and other overhead costs than is available to (Shipyard A).

Admiral Rickover Comment:

Shipyard A's costs should not be inherently higher than Shipyard B's. Several factors should contribute to lower -- not higher -- submarine overhaul and conversion costs at Shipyard A than at Shipyard B. For example:

a. Experience: Shipyard A has more experience in building and overhauling nuclear submarines than Shipyard B. Through October 1, 1971, the experience figures were:

	Shipyard A	Shipyard B
New Construction	35	22
Overhauls	12	9

b. Knowledge: Shipyard A has the advantage of having been both lead yard and planning yard for nearly all classes of nuclear submarines being overhauled.

c. Specialization: Shipyard A's operations are narrowly focused; the yard works almost exclusively on nuclear submarines for the Navy whereas Shipyard B is involved in a much wider variety of work. This should be to Shipyard A's advantage. On fixed price, new construction work where some element of competition is involved, Shipyard A has been very successful in winning contracts. Therefore, I see no reason why Shipyard A's costs should be higher than Shipyard B's on sole source,cost-reimbursement type,overhaul and conversion work.

C. NAVSHIPS Statement:

As I have previously reported to your committee, we have conducted a detailed study of the existing cost differential. As a result of our efforts, we have been able to identify several specific areas where it is believed costs at (Shipyard A) can be reduced and have so informed its management, requesting that they take appropriate action. I have also initiated action with both companies to improve their accounting and contract systems, which should improve our capability to make efficiency comparisons.

Admiral Rickover Comment:

In 1969, I reported that the Navy did not have effective cost controls over all work at its private shipyards. This is still the case today. While the Navy has taken some preliminary actions to improve its cost controls and accounting for work under new ship construction contracts, I am not aware of any -- and do not believe there is any -- equivalent action being taken to improve the cost control and accounting for work under ship overhaul and conversion contracts with private shipyards.

D. NAVSHIPS Statement:

> **The last submarine in the study that indicated that (Shipyard A) had received 18% more profit than (Shipyard B), while generating significantly greater costs, was completed in August of 1970. For the period since that time, the cost differential has been decreased by approximately 50% and the dollar profit received by (Shipyard A) on the contracts is 23% less than that received by (Shipyard B). Further, (Shipyard A's) profit as a percentage of total cost is 37% below that of (Shipyard B).**

Admiral Rickover Comment:

These figures are misleading. They imply that the Navy has taken action and, in fact, improved the situation by reducing costs and profits at Shipyard A. Actually, at the time the NAVSHIPS letter was issued, the Navy was continuing to negotiate and award submarine overhaul and conversion contracts which recognized much higher target costs and higher target fees at Shipyard A for comparable work. The differentials in negotiated target costs and target fees are about the same as they were when I first raised the issue. This can be seen from Table 2 below:

TABLE 2

COMPARISON OF TARGET COSTS AND TARGET FEES FOR SUBMARINE OVERHAUL AND CONVERSION WORK FROM MARCH 1968 THROUGH 1 NOVEMBER 1971

($ in millions)

SHIPYARD A	Date Contract Awarded	Negotiated Price Target Cost	Negotiated Price Target Fee	Price at Completion Actual Cost 1/	Price at Completion Actual Fee 1/
Ship #1	3/68	$29.0	2.8	$28.0	3.0
2	3/68	27.6	2.6	25.3	3.4
3	2/69	30.6	2.9	31.0	2.8
4	7/69	27.3	2.6	28.7	2.7
5*	11/69	27.5	2.8	27.5	2.9
6*	11/69	27.5	2.7	27.5	2.9
7*	2/71	28.5	2.7	Not Completed	
8*	2/71	28.5	2.7	Not Completed	
9	11/12/71	27.7	2.6 2/	Not Completed	
SHIPYARD B					
Ship #1	9/68	19.9	1.8	18.9	2.5
2	5/68	21.1	1.9	17.2	3.1
3	5/69	22.2	2.2	22.9	2.2
4	11/69	22.1	2.2	21.8	2.2
5	10/70	22.4	2.2	23.8	2.4
6	2/71	22.8	2.3	Not Completed	
7	7/71	22.1	2.2	Not Completed	
8	11/12/71	20.5	2.0	Not Completed	

* Average figures from two-ship contracts

1/ (NOTE)

Based on contractor billings thru Oct 1971. Figures may change due to final adjudication of change orders.

2/ These figures represent the procurement that the Naval Ship Systems Command negotiated and recommended for Chief of Naval Material approval. Upon learning that the Navy was again going to pay a substantial premium in both cost and profit to Shipyard A, I called the manager of Shipyard A. I told him he was insisting on a higher fee than Shipyard B who would be doing the job for about $7 million less. He agreed to reduce his target fee by about $600,000 to bring it in line with what the Navy would be paying the other shipyard. The NAVSHIPS procurement recommendation was revised accordingly. The final figures are: estimated cost $27.7 million; target fee $2.0 million.

The preceding comparisons show that the Navy negotiates and awards contracts with Shipyard A which, on the average, provide for about $600,000 more target fee and $6.6 million higher target costs per ship than contracts with Shipyard B. Until I personally intervened in the negotiations with Shipyard A for Ship #9 (after the NAVSHIPS November 5th letter was written), there was no significant reduction in target fees being paid the higher cost shipyard, contrary to the implication in the NAVSHIPS letter.

E. NAVSHIPS Statement:

> A special Business Review Team has been established to improve coordination between the Supervisors of Shipbuilding, our contract administrators in the field, and our procurement group at headquarters. It is under the team's direction that the current investigation is being conducted and under whom corrective action is being coordinated.

Admiral Rickover Comment:

New staffs have been formed, at headquarters and in the field, and new programs have been announced to strengthen the administration of shipbuilding contracts. However, these new organizations and programs suffer many of the same deficiencies as their predecessors. In some cases, field jobs have been filled by hiring contractor people. There is still a tendency to rely on "system" reviews and contractor procedures rather than checking on day-to-day happenings. Not much progress has been made in getting shipbuilders to institute effective internal audit programs of their own. When issues are raised, attention is usually focused on the specific situation used as an example rather than on the basic issue.

Rather than insisting on good people, good procedures, and good organization(s) in the administration of its contracts, the Navy has settled for more people, more procedures and more organizations. Rather than face the problems and solve them quickly, the Navy has resorted to "management programs" and acronyms. Although useful for public relations purposes, these management programs and acronyms have not contributed much toward resolving the problems.

P. NAVSHIPS Statement:

> In a further effort to stimulate management action toward improved efficiency, we are considering alternatives to our present procedures for determining profit. As you may know, we are examining the "return on investment" concept as a technique which, when combined with weighted guidelines, has the potential for providing a more effective means of motivating management to improve efficiency. In addition, it should provide a more equitable basis for rewarding their efforts. Whether the use of this technique will result in lower fees for a particular company cannot be known until a determination is made as to what elements will comprise the investment base, how they are to be weighted, what an appropriate return would be, and what the balance vis-a-vis weighted guidelines is to be, as well as other factors. Implementation will be accomplished through the Armed Services Procurement Regulation (ASPR) or in negotiations with contractors, on an individual basis, prior to such promulgation. I understand that the ASPR implementation plan will be submitted to the Deputy Secretary of Defense in December 1971.

Admiral Rickover Comment:

I have testified for many years that contractor investment should be considered in determining profits. My concern is that, in order to obtain industry acceptance of the new profit standards, the rules will be interpreted so that most defense firms obtain higher profits without any improvements in performance. Therefore, regardless of profit policy,the Navy must still concern itself with the difficult task of day-to-day surveillance of shipyard operations.

G. NAVSHIPS Statement:

In addition to the mentioned actions, members of my staff and I have personally discussed the need for reduced costs with senior executives at both (Shipyard A) and (Shipyard B).

It is my hope that the foregoing has provided a more complete picture of the Polaris/Poseidon overhaul and conversion procurement program, our problems related thereto, and the courses of action that we have chosen.

Admiral Rickover Comment:

Tables 1 and 2 of this enclosure provide a pretty complete picture of the Polaris/Poseidon overhaul and conversion procurement program. It shows tnat the courses of action chosen by the Navy have not led to noticeable improvement.

The Polaris/Posedion Program is vital to our national defense. It disturbs me that the Navy has been lax for so many years in looking into the costs of this program. Had this been done, it would have shown that the Navy could overhaul and convert 4 Polaris submarines at one shipyard for the price of 3 at the other. To all those interested in getting the most defense for the dollar, it is essential that these costs be brought under control. It is not yet clear to me that the Navy is committed to this objective.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON D C 20360

IN REPLY REFER TO
08H-513
22 Feb 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Employment of former shipbuilder personnel by Supervisors of Shipbuilding to monitor contractor performance on shipbuilding contracts

Ref: (a) NAVSHIPS 08 memo of 13 Sep 69 on Procurement Practices and Cost Control at Electric Boat
(b) NAVSHIPS 08 memo of 11 Sep 71 on employment of contractor personnel at SUPSHIP, Groton
(c) COMNAVSHIPS memo of 17 Jan 72 same subject as ref (b)

1. In June 1971 the Supervisor of Shipbuilding (SUPSHIP), Groton, hired an employee of Electric Boat to help him analyze Electric Boat's performance on Navy contracts. Not long afterwards an Electric Boat official commented on how nice it was "to have somebody we can work with in that job."

2. This remark crystalizes the problem in the practice of hiring an employee of a Navy contractor for a Navy position involving surveillance of the contractor. As I wrote you in references (a) and (b), it seems to me improper and unwise to place employees in a position where they are expected to review critically the performance of their friends and former colleagues. This is true even though the employee is a person of scrupulous integrity. There can still be the appearance of favoritism, although none may exist in fact. Because it is essential for the Navy to avoid even the appearance of impropriety, I have recommended that NAVSHIPS adopt a policy of not hiring contractor personnel for positions involving contract administration or surveillance at their former place of employment.

3. In reference (c) you reported that you plan to issue instructions to the effect that employment by the contractor shall be considered an adverse factor when selecting employees for administration or surveillance positions in the SUPSHIP

offices. I would appreciate getting a copy of the instructions you have issued. If it turns out in practice that the instructions do not eliminate the hiring of former contractor employees, additional steps will be in order.

H. G. Rickover
H. G. Rickover

cc:
NAVSHIPS 02
NAVSHIPS 05
NAVSHIPS 00J

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

08H-518

28 FEB 1972

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Progress Payments on Nuclear Shipbuilding Contracts

Ref: (a) My memorandum Ser 08H-1478 dtd 14 July 1971 to ASN (I&L)
(b) My memorandum Ser 08H-1496 dtd 2 Oct 1971 to ASN (I&L)

1. In references (a) and (b), I pointed out that progress payments on most major Navy shipbuilding contracts are more liberal than on other contracts for military equipment. I cited examples showing that loose government administration of progress payments is allowing shipbuilders to obtain what are in effect multi-million dollar, interest-free advances of government funds beyond those required to perform Navy contracts. I stressed the need for better administration of progress payments to avoid overpayments on shipbuilding contracts.

2. As a result of my memoranda, the Navy recently has taken some steps to remedy the situation. The Comptroller of the Navy established a Special Task Group to review current policies and to determine what changes are needed. The Naval Ship Systems Command is attempting to get cash flow data from shipbuilders. Supervisors of Shipbuilding are beginning to raise progress payment issues with contractors. Some progress is apparent.

3. Recently, I learned of yet another defect in our present shipbuilding progress payment procedures. Navy fixed-price-type shipbuilding contracts provide for progress payments based on physical progress, except that such progress payments may not exceed 105 percent of incurred costs. However, I find that Newport News Shipbuilding and Dry Dock Company, for example, includes unallowable costs in its calculation of the 105 percent limit. While the government auditor disallows such costs in the final contract settlements, these costs apparently are not deducted from the progress payment billings. As a result, the government is financing these unallowable costs through progress payments to the shipyard.

4. In 1970, the latest year for which firm information is available, the resident government auditor identified unallowable costs totaling $2.3 million -- about 1.5 percent of total overhead costs -- in Newport News' overhead accounts. The unallowable costs are as follows:

Item	Unallowable Costs	
	Amount	% of Total
Pension Fund Adjustment	$1,107,822	49%
Commercial Selling Expense	566,310	25
Research & Development for Commercial Work	221,854	10
Advertising	118,458	5
Adjustment of Maintenance & Repair Costs	103,116	4
Commercial Shipyard Study	57,344	2
Entertainment	35,179	1
Contributions	31,945	1
All Other Unallowable Costs	69,041	3
	$2,311,069	100%

By not eliminating these unallowable costs from progress payment claims, the Navy ends up financing many costs which relate strictly to commercial work, as well as other costs that the government auditor has determined to be improper under the circumstances. I understand that this situation also obtains at other shipyards.

5. In addition to being a costly practice, it is also wrong in principle. It is wrong for the taxpayers to finance the shipbuilder's commercial work as well as costs which previously have been determined as a matter of public policy to be unallowable. I recommend that the Navy amend its procedures so that such costs are excluded from progress payment calculations.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy (Financial Management)
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20350

2 3 MAR 1972

MEMORANDUM FOR VADM RICKOVER, USN, DEPUTY COMMANDER FOR NUCLEAR PROPULSION, NAVAL SHIP SYSTEMS COMMAND

Thank you for your memorandum of 28 February 1972, expressing further your views on the effect of current shipbuilding progress payment practices. You also noted that this subject has been under study by a special Task Group. The Assistant Secretary of the Navy (FM) and I jointly agreed to form this Task Group as a result of a recommendation included in the Industry Advisory Committee Report of June 1971. The Task Group was established by provision of a memorandum of 3 August 1971. The report prepared by this Task Group will be distributed for comment within the next few days. I am advised that a copy will be forwarded to you.

Your recommendation that the Navy amend its procedures related to progress payments substantially agrees with the recommendations proposed by this special Task Group studying Shipbuilding Progress Payments. After appropriate coordination of the Task Group's efforts, the present method of making progress payments based on a percentage of completion may be changed to a method based on costs incurred as provided in Appendix E to ASPR, subject to variations suggested by the Task Group. Implementing instructions will be promulgated at the earliest practicable date.

Prior to the establishment of the Task Group, the Defense Contract Audit Agency and SUPSHIP Newport News initiated certain discussions, which resulted in NNS&DDCO making certain adjustments in their accounting practices, most of which were effective 1 January 1971 with the remainder becoming effective 1 January 1972. I am told that adjustments eliminated the accounting deficiencies shown in your tabulation of unallowable costs. I understand that the tabulated unallowed costs included in your memorandum are overstated by $710,155 due to the credits shown in the Audit Report.

To appraise the effectiveness of the systems established, prior to your memorandum of 28 February 1972, the SUPSHIP Newport News conducted an analysis of current contracts to determine the amount of unallowable costs included in progress payment vouchers. The analysis disclosed that no progress payments which include such costs have been made since 30 September 1970. Progress payments since that date have been made entirely on the basis of percentage of physical completion. It should be noted that of the $2,311,069 gross unallowable costs shown in the audit report, only $73,345 was actually included in progress payments under Navy contracts for the year 1970. The financing cost of this amount saved by the contractor for 1970 computed at 8% would not have exceeded $2,500.

I also believe that it is wrong for the tax payers to finance shipbuilders' commercial work if the financing is a result of improper billings. However, as stated above, procedures have been instituted by the Supervisor of Shipbuilding to prevent payment of progress payments which are not based on proper accounting procedures.

By copy of this memorandum, the Chief of Naval Material is requested to continue to monitor the shipbuilding program and to keep me advised of any inadequate administration of progress payments which may occur. I appreciate your interest and agree with you that overpayments on shipbuilding - or for that matter on any Government contract - should be avoided.

CHARLES L. ILL
Assistant Secretary of the Navy
(Installations and Logistics)

Copy to:
CNM

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO

27 MAR 1972

MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Progress Payments on Navy Shipbuilding Contracts

1. On 28 February 1972 I pointed out that under current procedures shipbuilders may include unallowable costs and costs that are not allocable to Government work in progress billings under fixed price shipbuilding contracts. I recommended that the Navy amend its procedures so that such costs be excluded from progress payment calculations.

2. Your 23 March 1972 memorandum responded that:

a. My recommendation that the Navy amend its procedures related to progress payments substantially agrees with recommendations proposed by the special task group studying shipbuilding progress payments.

b. Prior to the establishment of the special progress payment task group, the Defense Contract Audit Agency and the Supervisor of Shipbuilding had initiated actions which resulted in changes in the Newport News Shipbuilding and Dry Dock Company accounting practices and eliminated the accounting deficiencies shown in the tabulation of unallowable costs included in my 28 February 1972 memorandum. Your memorandum also indicated that I had overstated by $710,000 the 1970 unallowable costs at Newport News through the omission of credits shown in the audit report.

c. Prior to my 28 February memorandum, the Supervisor of Shipbuilding had made an analysis of Navy contracts to determine the amount of unallowable costs included in progress payment vouchers. This review indicated that no such costs have been paid since September 1970, and that for all of 1970 only $73,000 in unallowable costs were included in Navy progress payments, but that interest on this amount would have not exceeded about $2,500.

You concluded that procedures had been instituted by the Supervisor of Shipbuilding to prevent payment of progress payments not based on proper accounting procedures. You requested the Chief of Naval Material to continue to monitor shipbuilding programs and advise you of any inadequate administration of progress payments which may occur.

3. I submit that the sum and substance of my 28 February letter is not a mere $2,500 matter. The basic issue I raised involves substantial sums not only at Newport News but also at other private shipyards. If the Navy is to administer its contracts properly, it cannot leave loopholes in its procedures which can be exploited by contractors. For these reasons I do not agree with your apparent decision to take no further action on this matter.

4. Several statements in your 23 March memorandum are at variance with the facts as I know them. Taking your comments in order:

a. Changes in Newport News Accounting Procedures. The changes in Newport News accounting procedures in January 1971 and in January 1972 had the effect of reducing Defense Contract Audit Agency disallowances, not eliminating them as your memorandum implies.

On March 21, 1972, the resident Defense Contract Auditor at Newport News advised the Supervisor of Shipbuilding that he estimated unallowable costs to amount to about .6 percent of direct labor costs in 1971 and 1972. This would amount to about $700,000 a year for Navy work. The auditor further stated that Newport News agreed with this estimate and would reduce billings under cost type contracts by .6 percent of direct labor cost in order to eliminate unallowable costs. The company, however, refused to eliminate this amount voluntarily from progress payment calculations under fixed price incentive shipbuilding contracts. According to the Supervisor of Shipbuilding, most of the accounting changes were made effective in January 1972, not in January 1971, as stated in your memorandum.

b. Overstatement of Unallowable Costs. Your memorandum indicates that I overstated the 1970 unallowable costs at Newport News by $710,155, by omitting credits shown in the audit report.

The $710,155 in credits includes audit adjustments that Newport News is entitled to as a result of disallowances prior to 1970 and other credits to which Newport News would be entitled even if there were no audit disallowances in 1970. Thus, the credits do not affect the amount of cost disallowances listed in my memorandum. The point I made was that by not eliminating these unallowable costs from progress payment claims, the Navy ends up financing many costs which relate strictly to commercial work, as well as other costs that the auditor has determined to be improper under the circumstances.

c. Supervisor of Shipbuilding Review of Unallowable Costs. Your memorandum states that prior to my 28 February memorandum the Supervisor of Shipbuilding made a review which indicated that since 30 September 1970 no progress payments had been made which included unallowable costs. It further states that progress payments since that date have been entirely on the basis of percentage of physical completion.

My review indicates that this is not correct. According to the Supervisor of Shipbuilding, his review was made after my 28 February memorandum, not before. Moreover, I find that Newport News' progress billings in 1971 include several billings on a cost-incurred basis for the DLGN 36 and 37 (January, 1971) and on the SSN 686 (January to March, 1971). Progress billings made in 1972 include several billings on a cost-incurred basis for DLGN 38 (February and March, 1972) and on SSN 689 (March, 1972). Further it does not appear that the Supervisor of Shipbuilding has eliminated any unallowable costs from these billings.

My review further indicates that, except for a Newport News change in their method of calculating progress payments under that contract, most of the costs billed under the DLGN 36 and 37 contract in 1971 would have been billed on a cost-incurred basis. As I have previously pointed out to you, I do not agree with the Newport News change in method of billing progress payments on this contract. This matter is presently undergoing legal review in NAVSHIPS for a determination. If my interpretation of the contract is correct, then the unallowable costs reimbursed under this contract alone was about $145,000 in 1971.

5. The Navy must have a clear policy that unallowable costs are to be eliminated from all progress payment calculations. As I stated in my 28 February memorandum, this problem is not confined to Newport News. For example, Electric Boat billings under fixed price incentive contracts also include unallowable costs in progress payments processed on the basis of costs incurred. The Navy should stop this practice, not only at Newport News and at Electric Boat but at all shipyards.

6. I again recommend that you issue instructions to eliminate unallowable costs from progress payment calculations. Action on existing contracts can and should be taken now. The Navy should not wait until the overall issue of shipbuilding progress payments is settled. That may take months or even years.

7. I hope you will reconsider your position and issue instructions along the lines I have suggested.

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
OFFICE OF THE SECRETARY
WASHINGTON, D. C. 20350

21 APR 1972

MEMORANDUM FOR VADM RICKOVER, USN, DEPUTY COMMANDER FOR NUCLEAR PROPULSION, NAVAL SHIP SYSTEMS COMMAND

I have reviewed your memorandum of 27 March 1972 addressing progress payments on shipbuilding contracts together with the Naval Material Command policy issued 6 April 1972 governing the treatment of incurred costs for progress payment purposes. This policy is consistent with the actions I requested the Chief of Naval Material to take in my memorandum of 23 March to you on this subject. I believe, with proper administration, that a uniform treatment of costs for progress and final contract payment purposes should overcome previous deficiencies encountered in progress payments and eliminate unallowable costs from payments made.

I am also hopeful that the recommendations made by the Task Group on shipbuilding progress payments jointly formed last August by ASN(FM) and ASN(I&L) can be promptly reviewed and coordinated to allow early consideration of their adoption by the Navy. I understand your comments are being sought on these recommendations and I shall look forward to learning your views.

In discussions last week between representatives of our staffs and ASN(FM), I understand that the matter of progress payments was reviewed at some length and general agreement was reached that current policy should substantially improve the quality of payments made.

CHARLES L. ILL
Assistant Secretary of the Navy
(Installations and Logistics)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
Ser 08-1801
27 March 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Overtime and Productivity in Shipyards

Ref: (a) VADM Rickover Memorandum to Commander, Naval Ship Systems Command Ser 080-13 of 27 Jan 72
(b) Commander, Naval Ship Systems Command Memorandum to VADM Rickover Ser 17-00 of 3 Feb 72

Encl: (1) Examples of Abuses of Overtime in Shipyards
(2) Examples of Lack of Productivity in Shipyards

1. In reference (a), I requested that information on overtime expenditures in Naval shipyards be provided to me monthly. This information would permit me to evaluate the extent to which overtime is being used and abused on reactor plant work and to form the basis for corrective actions. In reference (b) you replied that you look to the Shipyard Commanders to control the use of overtime within the instructions given them and within the limits imposed by the Chief of Naval Material. You stated that overtime usage is audited frequently by the Naval Area Audit Service and by other inspections as they occur. You requested that if I am aware of cases of abuse, I should inform you.

Reference (b) goes on to state that you have no objection to providing a portion of the information I requested -- that pertaining specifically to overtime work on the reactor plants of nuclear powered ships -- but that the remainder of the information I requested concerning overtime would not be provided since the information is not currently required or available in existing reports.

2. I submit that I do not understand why you turn to me for information on abuses of overtime. This suggests that unless I can provide you with sufficient examples, the problem does not exist. Nevertheless, it is common knowledge that overtime has been abused for years. Commanding officers of both new construction ships and ships in overhaul have informed me of numerous examples. Shipyard officials have acknowledged abuses to me. My own observations and those of my representatives at shipyards on numerous occasions have confirmed that the problem exists. Just last year the report of a Naval Area Audit Service review of a Naval shipyard showed that 46 percent of the overtime worked on three successive weekends by two production shops was questionable.

Clearly, there are a number of sources to which you can turn to learn of overtime abuses. I do not have the staff whose primary responsibility is to look into such matters. However, as you requested, I am providing in enclosure (1) examples of abuse of overtime in both Navy and private shipyards.

3. I recognize fully the need for some overtime for emergencies and for work which is delaying major programs. However, abuses of overtime contribute to the high cost of ship work. More than $100 million was spent on overtime by Naval shipyards in fiscal year 1971; undoubtedly million of dollars were spent on overtime in private yards as well. The examples listed in enclosure (1) show that much of this money is wasted. The examples can be categorized as follows:

a. Long term planned use of overtime. Shipyards have established quotas for overtime to be used routinely, week after week, month after month, on the basis that such overtime is required to meet schedules. Enclosure (1) discusses an example in which the Production Officer at a Naval shipyard was using a quota of 1500 overtime man-days per week because he considered his work force was less than the estimated number needed to meet schedules. This quota was established without regard to the specific jobs for which overtime might be justified and amounted to $225,000 a week in overtime costs. I question whether improved work progress, if any, is worth the large additional costs incurred by such routine and perfunctory use of overtime.

b. Overtime used for jobs that are not controlling completion of ships. Examples listed in enclosure (1) such as use of overtime for sweeping a shop or painting the numbers on a ship's hull months before the ship is to go to sea indicate that the importance or timeliness of the job is not considered in assigning overtime.

c. Excessive overtime pay to individuals. Overtime pay has exceeded half the basic salaries of some shipyard employees including senior shipyard managers. In one case listed in enclosure (1), a shipyard supervisor doubled his regular annual salary by working overtime. Excess overtime pay is particularly repugnant in the case of senior shipyard managers who should be setting the example. Enclosure (1) lists another example in which, over a period of years, the Planners and Estimators in one shipyard have routinely worked 4 hours overtime on Tuesdays and 4 hours overtime on Thursdays, regardless of the yard workload. The Shipyard Commander was not aware of this situation until I informed him. It is clear that employees, including their supervisors, have become accustomed to receiving overtime pay as a normal and expected routine. This has evolved into a "right" which management is expected to provide regardless of the need.

d. Extensive overtime used by inefficient yards. Use of overtime is particularly ineffective and costly when shipyard productivity and efficiency is low. Both Navy and private shipyards have excessive numbers of idle workers. This is worse on weekends because then there is often less supervision and less management attention. Furthermore, support services are not readily available during weekends, particularly if something unusual arises. Enclosure (1) refers to checks my representative made in one yard. These showed that during a recent weekend 44 percent of workers observed were idle; weekday checks showed only 31 percent of workers observed were idle.

4. Overtime could be largely eliminated if productivity were even partly improved. I have personally seen, and I continue to receive reports of gross inefficiency in both Naval and private shipyards. So much idleness is apparent that it is difficult to understand why any overtime is warranted. I have listed in enclosure (2) examples of lack of productivity in shipyards; these will be of value to you in understanding the true overtime situation. The examples indicate that:

a. Large numbers of people are idle at all times -- day and night.

b. People arrive at work sites long after the work shift has begun and line up to get off the ships well before the end of the shift.

c. People leave early for lunch and return late.

d. There are many places in shipyards where employees hide out. Such places — commonly small sheds or shacks near the waterfront — serve no useful purpose and should be eliminated.

e. Excessive numbers of people are assigned to jobs.

5. I have not identified the specific yards in enclosures (1) and (2). I can give the name of the yard in each example if you wish; however, similar examples exist at all yards — and for anyone to see. It appears to me that the NAVSHIPS Deputy Commander for Field Activities who is responsible for managing Naval shipyards and those in NAVSHIPS responsible for Navy work in private yards should be able to give you many examples. The examples in enclosures (1) and (2) illustrate that those responsible have not effected lasting improvements. That Government money should be spent as if it were their own, is a concept not ingrained in these officials.

Despite the ineffective use of personnel, the loafing, the idleness, and the abuse of overtime, I am not aware of anyone in NAVSHIPS who is taking action to reduce overtime below that set in December 1971 by the Chief of Naval Material as an upper limit. In fact, the opposite appears to be the case. Recently NAVSHIPS directed a reduction in force in Naval shipyards. Even though one yard advised NAVSHIPS that overtime is an undesirable alternative for solving workload problems during this mandatory reduction in force, the yard's overtime allowance has been raised by NAVSHIPS from 5 percent to 9 percent. At the same time, my representative in that yard reported that an average of 32 percent of all workers he observed over the past three months were idle.

6. I recommend that you take measures to eliminate overtime abuses and to increase productivity in both Naval and private shipyards. Attempts to solve these problems in Naval shipyards by conducting more studies or establishing more management systems should be stopped; these are but palliatives to avoid facing up to the problems. To lessen the problems will require substantive actions and constant firm direction to assure the actions are carried through. The situation will not improve until those responsible for managing the yards actually manage them, instead of merely acting as custodians.

The situation is so bad within NAVSHIPS itself that when, in April 1971, NAVSHIPS rated the results of an inspection of productivity at a Naval shipyard as "excellent", the Shipyard Commander himself requested that the rating be changed to "marginal". The Shipyard Commander knew that productivity was not excellent — that in fact it was poor. This exemplifies the need to improve the performance of your subordinates who are responsible for shipyard management or, failing that, to replace them.

7. Regarding the overtime information I requested in reference (a), I do need the statistics on reactor plant work which reference (b) indicates you have no objection to providing. I have learned that the NAVSHIPS Comptroller already issues a monthly report which summarises Naval shipyard operating financial data and that this includes the total monthly overtime for each Naval shipyard. I have arranged to receive a copy of this report. I still desire the remaining information I requested on overtime expended on nuclear ship work other than reactor plant work. These data would place the reactor plant overtime work in perspective with other work and assist me in determining the validity of overtime expended on the work under my cognizance.

8. As to private shipyards, you sent a message to Supervisors of Shipbuilding on 7 January 1972 directing that they review overtime worked by private shipyards on Navy work. The message stated that NAVSHIPS will not accept as reasonable the continued use of substantial amounts of overtime where the cost is borne partially or in whole by the Government, unless the overtime has been specifically justified to the Navy. The message required Supervisors of Shipbuilding to obtain from the private yards monthly reports of overtime used on Navy contracts. However, these reports, of themselves, will not reduce overtime. Over the past month, one private yard has continued to average about 3000 overtime man-days of direct labor per week -- 15 percent of the total direct labor man-days worked in the yard each week.

It is clear to me that the situation with regard to overtime and productivity in private yards needs considerably more attention than your message requests. I recommend that you request Supervisors of Shipbuilding to look specifically for and report abuses of overtime and poor productivity to senior shipyard management. Their findings as well as corrective actions that have been taken by the shipyards should be summarized in periodic reports to you.

H. G. Rickover
H. G. Rickover
Deputy Commander for
Nuclear Propulsion

Copy to:
Chief of Naval Material

Enclosure (1)

EXAMPLES OF ABUSES OF OVERTIME IN SHIPYARDS

The following examples of overtime abuses have been compiled from observations by NAVSHIPS 08 personnel and Naval Reactors Representatives, from reports by commanding officers of both new construction ships and ships in overhaul, and from statements of shipyard personnel. These examples should not be construed as a comprehensive listing of overtime abuses. They serve only to illustrate the numerous abuses of overtime which have occurred and continue to occur in shipyards.

A. Long Term Planned Use of Overtime

1. At one Naval shipyard, the Production Officer stated that he was using a quota of 1500 overtime man-days per week because he considered that an analysis of the yard's workload indicated that his work force was 300 men short of the estimated number needed to meet work schedules. In a five day week, 300 men could work 1500 man-days, hence the quota of 1500 man-days per week. This quota was established without regard to the specific jobs for which overtime might be justified and amounted to $225,000 in overtime costs.

At the same time, representatives from NAVSHIPS 08 noted that between 45 and 55 percent of workers observed in this yard during normal working hours were idle. Even a small improvement in the utilization of personnel during normal working hours would offset the need for much overtime. The NAVSHIPS 08 representatives observed specific examples of improper use and control of overtime; these included:

a. A job was worked for six overtime shifts on Saturday and Sunday, but on Monday the incomplete job was not being worked.

b. One production manager approved the jobs to be worked on an overtime basis but did not approve the amount of overtime to be worked.

c. A shipyard official pointed out that annual leave is often taken on Mondays and Fridays by employees who work overtime during the weekend.

2. On a ship that started overhaul in July 1971, about 17 percent of the total labor expended on the ship has been overtime, yet the ship is not scheduled to complete overhaul until December 1972. The shipyard was planning to conduct certain refueling work in this ship on a twelve-hour shift basis during the work week and on weekends. After the Naval Reactors Representative brought this to the attention of the Shipyard Commander, the yard changed its plans to conduct the same work on an eight-hour shift basis during the week with no planned weekend overtime — yet without lengthening the refueling schedule. As a result of this action approximately 750 man-hours of planned overtime per week were eliminated.

During the time the above plans were being made to work excessive overtime, the yard was publically admitting that the yard workload was down and that some workers might have to take forced leave.

The abuse of overtime in this yard had been pointed out by the Naval Area Audit Service on at least two separate occasions with no apparent results. In the latest audit report of a year ago, the following statement was made by the Naval Area Audit Service:

> "Controlling Overtime: Overtime worked by (two production) shops on three successive weekends that we reviewed totaled 13,300 man-hours. The need for 6,211 man-hours, or 46 percent, was questionable. Based on the period reviewed, it is estimated that there is a potential annual savings of about $467,000 in overtime premium cost. The savings can be realized by determining the necessity of the requested overtime on the basis of the scheduled start and completion dates for the work. This condition was reported in a prior audit report."

B. Overtime Used for Jobs Not Controlling Completion of Ships

1. During a weekend at a shipyard, the following were observed by the Naval Reactors Representative:

a. Four men were observed in the machine shop. One was repairing a bicycle, one cleaning the floor, and two loafing.

b. Ten men were noted performing maintenance work on railroad tracks leading to an area for which other means of transporting materials existed.

c. Four men working on a portal crane for which there was no immediate need.

In addition, during the same weekend the Naval Reactors Representatives observed:

d. Two machinists sitting on a pier reading a newspaper during working hours.

e. Three inspectors loafing in a storage warehouse.

f. A man was observed in the machine shop working on a shotgun. A time card on the work bench where he was working indicated he was being paid for his time.

During the same week, in which the above misuses of overtime occurred, 32 percent of workers observed in the shipyard during the normal work week were idle.

2. The following similar examples were noted by a Naval Reactors Representative during a weekend at another yard:

a. Thirteen men were noted working on routine maintenance jobs such as clearing rocks from a storage area.

b. Of twenty-seven men observed in a pipe shop, no more than five were actually working, and they appeared to be working routine jobs.

c. Four men were sorting junk in the scrap yard.

d. Three men were working on hull frames for a ship for which the keel will not be laid until June 1972.

e. One man was painting the sail number on a ship which was not to go to sea for five months.

3. At one yard, a planner was called in on Saturday to work overtime issuing routine paper work needed to document a job which had been completed the previous Friday. This paper work should have been done during the next normal working day to avoid the extra cost associated with overtime work.

4. A yard had worked overtime hours at the rate of 19 percent of the total regular hours worked on the reactor plant of a submarine in overhaul--yet the reactor plant work had never been the controlling factor in the length of the overhaul. As a result, the yard discovered that with 33 percent of the scheduled length of the ship's overhaul remaining, 95 percent of the funds allotted for overhaul of the ship's reactor plant was expended.

C. Excessive Overtime Pay to Individuals

1. In one yard, a trade supervisor doubled his regular annual wage by working overtime. By the end of the year, his annual income was approximately $8,000 more than that of the Shipyard Commander. In that same yard, four supervisors increased their 1971 salaries by approximately 30 percent by working overtime.

2. At another Naval shipyard, at least 80 employees worked over 500 hours of overtime in 1971. Based on a nominal work year of 2000 hours and time and a half pay for overtime, these workers all earned an additional 37 percent of their base salary in overtime pay. One worker had 1448 hours of overtime work -- an average of four hours per day for every day of the year. Thus, this one worker made more than double his base annual salary through overtime work.

3. Planning and Estimating personnel routinely worked four hours overtime every Tuesday and every Thursday in one yard. This practice had been customary for many years without regard to actual yard workload. The Shipyard Commander was not aware of this situation until advised by the Naval Reactors Representative.

4. The eleven members of a trade in one shipyard earned from 471 to 733 hours of overtime during the past year. These overtime hours represented an increase of between 35 and 50 percent in the amount these tradesmen earned over their base pay for the year. One of these workmen wrote to VADM Rickover complaining that the lack of a security clearance was keeping him from getting his "fair share" of overtime; yet this man had earned 617 hours of overtime in the year, fifth from the highest in his trade.

5. At another shipyard, in the midst of a drive to reduce overtime throughout the yard, overtime hours earned by 39 yard employees amounted to 30 percent of their regular time hours during a four-week period. One of these people worked 59 percent overtime, or more than 4 hours overtime for each 8 hours of regular time, over the entire four-week period.

Enclosure (1) to
Ser 08-1801

D. Extensive Use of Overtime in Inefficient Yards

1. On a Sunday morning in one yard, the Naval Reactors Representative observed one worker reading a newspaper and two reading pocket books onboard a repair barge.

2. At another yard, at least six men were assigned to weekend support of a shipboard test, but only one was observed by the Commanding Officer of the ship to be busy at any given time.

3. In an attempt to make up delays which had occurred during the overhaul of a nuclear submarine, more than 100 pipefitters at one shipyard were assigned to work two hours overtime each week day and one whole day each weekend. In one day during this same period of time, 90 pipefitters were observed by the Naval Reactors Representative standing idle in a waterfront staging area during normal working hours.

4. A shipyard security guard found five people sleeping in a pipe shop area early on a Sunday morning. These people were assigned overtime ostensibly to support testing on a nuclear submarine.

5. In another yard, 44 percent of workers observed by the Naval Reactors Representative during a weekend were idle. By comparison, an average of 31 percent of workers observed were idle during normal working hours that week.

6. Additional typical abuses of overtime noted by the Naval Reactors Representative at a yard over a weekend were:

   a. One worker standing in the crew's mess of a ship eating donuts and drinking coffee.

   b. Two workers loafing in a ship's compartment.

   c. Five workers standing together — three reading newspaper and two engaged in a discussion not related to their work.

   d. One person picking up trash around a drydock.

Enclosure (2)

EXAMPLES OF LACK OF PRODUCTIVITY IN SHIPYARDS

The following examples of lack of productivity have been compiled from observations by NAVSHIPS 08 personnel and Naval Reactors Representatives, from reports by commanding officers of both new construction ships and ships in overhaul, and from statements of shipyard personnel. These examples should not be construed as comprising a complete listing of instances of poor productivity. They serve only to illustrate the unsatisfactory situation concerning idleness, loafing and inefficiency in shipyards.

A. Borrowing Personnel from Other Yards

One Naval shipyard has recently considered it necessary to borrow about 140 mechanics from other shipyards. These people are paid per diem as well as their regular pay and the Government has paid travel costs. Yet the need for their assistance is at least questionable; in the same yard, the Naval Reactors Representative reported over a week's time that an average of more than 50 percent of workers observed were idle.

One of the borrowed workers privately stated that he didn't mind getting the extra pay but that he had been in the yard for one week, had been in a pay status all seven days (two on overtime) but had only accomplished one and one-half hours of work.

At the same time that these 140 borrowed mechanics were working in the yard, the Naval Reactors Representative pointed out to the Shipyard Commander that the station bill for the defueling of one ship was padded with extra employees. As a result, over 20 percent of the workers were removed from the bill. However, the Naval Reactors Representative later observed that many of the workers who had been removed from the bill were still being charged to the defueling work and were being used to provide frequent reliefs for those manning the job. The Naval Reactors Representative also noted that some of the workers left on the station bill were not being utilized effectively. In one case a worker was being charged to the defueling operation for a complete eight hour shift but the task he was assigned to perform took only ten minutes of the shift.

B. Lack of Supervision

1. During surveillance inspections by the Naval Reactors Representative in one Naval shipyard, 56 percent of the workers noted in shop areas were not working. Many were gathered in small groups talking and drinking soft drinks. In ten of eleven small groups of non-workers observed, supervisors were present and were contributing to the idleness.

Enclosure (2)

2. A number of pipe and machine shop personnel at a Naval shipyard were observed by the Naval Reactors Representative to be standing around with nothing to do because of radiography work which interfered with the work to which they had been assigned. None of the men had been assigned backup work by their supervisors.

3. A ship Commanding Officer was concerned enough about loafing of shipyard workers aboard his ship to write a memorandum to the Shipyard Commander reporting that he had observed the following two repetitive situations while making tours of his ship:

a. Workmen not always employed in productive work.

b. A sparsity of supervisors on the ship. He added that about 90 percent of the workers on his ship discontinued work en masse from 9:00 to 9:30 AM and from 2:00 to 2:30 PM each day for coffee. Moreover, he stated that work usually ceased 20-25 minutes prior to lunch breaks and shift changes.

4. Another ship Commanding Officer stated that idle conversation by unsupervised yard workers is the principle cause of continuing non-productivity on board his ship.

5. In a shipyard, a worker who had been assigned to a specific job was observed by the Naval Reactors Representative to be doing nothing for three hours. No supervisor checked on the man during the entire three hour period.

6. In one private shipyard, a high weld reject rate has been a continuing problem. After this problem had been brought to the attention of shipyard management and corrective actions were to have been taken, the Naval Reactors Representative conducted a number of surveillance inspections at welding work sites over a period of a week. No welding supervisors were present at the work sites during at least half the inspections, no supervisors were noted actually watching welds being made, and not one welding engineer was observed at the work sites where welding was in progress.

7. In one private shipyard, a Naval Reactors Representative observed significantly large numbers of workers over a long period of time to determine the number of idle workers at various times during a shift. Over 34 percent were observed idle during the middle of shifts, approximately 36 percent were idle one and one-half hours prior to the end of the shift, 40 percent were idle by one hour before end of shift, and 48 percent were idle one-half hour before the end of shift.

Enclosure (2) to
Ser 08-1801

Enclosure (2)

C. Personnel Not at Their Assigned Work Sites

1. At one shipyard, a job was planned to be accomplished in three to four shifts. After thirteen shifts had been spent on the job, a meeting among concerned parties was convened. The work was then completed in approximately six hours. A subsequent review by the Naval Reactors Representative and a NAVSHIPS 08 representative of entry records at the work site indicated that during the initial thirteen shift period the first production shop person entered the work site an average of two hours after shift commenced, and the last production shop person left the site an average of one and one-half hours before the end of shift. In addition, on both day and swing shifts, the average elapsed time was two hours from when the last production shop person left the work site prior to lunch until the first production shop person returned to the site after lunch.

2. The Naval Reactors Representative observed that all workers assigned to a particular job in one yard left work at least 25 minutes before the end of the day shift. At another time during the previous week, more than half of the workers observed at the job site had left at least 40 minutes before the end of shift.

3. At the suggestion of the Naval Reactors Representative, a shipyard conducted a specific gate check on a swing shift prior to and after the dinner break. As a result, four employees were disciplined for leaving early for and returning late from dinner.

4. Approximately 35 minutes after the start of a shift at one yard, not one of 30 workers aboard a ship had started to work. Workers were noted by the Naval Reactors Representative and the ship Commanding Officer straggling to the ship for at least 15 minutes subsequent to that.

5. No lunch period is scheduled for production personnel on the midnight to 8:00 AM shift in one shipyard. The Naval Reactors Representative observed that a one and one-half hour lunch break was being taken during this shift by personnel assigned to a dockside refueling facility. After the Naval Reactors Representative pointed this out to the Shipyard Commander, the lunch break was reduced to 45 minutes but was not eliminated.

6. Ten shipyard workers were observed aboard a ship by a Naval Reactors Representative during the last two hours of a day shift. One of the workers left the ship one and one-half hours before the end of the shift stating he was through for the day, and four more left 40 minutes before the end of the shift. These workers are still paid for the full eight hour shift.

Enclosure (2)

D. Additional Examples of Poor Productivity

1. In one shipyard, at least 50 portable shacks were located within 75 yards of a nuclear submarine in overhaul. Some of these structures were equipped with heat, air conditioners, seats, radios, coffee messes, and Playboy pin-up galleries. In at least two cases, employees had constructed these shacks from scrap materials. The insides of these units were made obscure by curtains, tape, or paint over the windows which prevented seeing into the shacks. On many occasions the Naval Reactors Representative found shacks locked from the inside.

In another yard, similar buildings were noted along a drydock. These were serving no useful purpose other than to provide a place to loaf out of sight and out of the rain. Such shacks have also been observed in other shipyards.

2. The Commanding Officer of a ship in one yard reported that his crew found two dozen empty liquor bottles as they toured the ship at the end of the December holiday season. He thought it to be inconceivalbe that the supervisors were not aware of this amount of drinking. He identified this problem to the yard, but subsequently found more liquor bottles on two separate occasions. A similar incident was reported by a ship Commanding Officer at another yard during this holiday season.

3. During working hours in one yard, a worker was noted skinning a deer tail to obtain materials for refurbishing fishing lines.

4. Productivity was observed to be unusually good aboard one ship in a Naval shipyard just prior to an announced Shipyard Commander's inspection. Immediately after the inspection, 30 percent of the workers aboard the ship were noted to be idle by the Naval Reactors Representative. In this same yard, the Naval Reactors Representative observed that the number of idle workers averaged about 32 percent, yet the yard requested relief from manning and overtime constraints claiming delays would occur in completing the overhauls of Fleet Ballistic Missile submarines if relief was not provided.

5. Five shipyard workers were turned in by ship's force personnel in one yard for shooting craps in the radio room of the ship. These workers had actually posted a lookout to warn the players of approaching outsiders.

6. At another shipyard, the Naval Reactors Representative noted several instances of welders spending work time engaged in activities obviously not connected with their jobs. One was working on what he considered a "beneficial suggestion" for which he hoped to receive a monetary award. Others were noted fabricating items such as small ladders for their personal use.

7. The Naval Reactors Representative at a Navy yard noted some blatant cases of loafing including shop people congregating in lavatory facilities drinking coffee and a fork lift operator teaching a cafeteria worker how to swing a golf club outside of the cafeteria during working hours—not during the lunch period.

8. A Commanding Officer of a ship in one yard observed much loafing in the propulsion plant spaces onboard his ship. After pointing this out to yard management, he noticed that the loafers moved to other compartments of the ship such as the sonar equipment room. In one day he personally observed over 30 workmen doing nothing (in his opinion, hiding) in ship's compartments outside the propulsion plant spaces.

9. In at least two instances, the reaction of yard management or the Commanding Officers of ships to minor improvements in the number of idle workers has indicated how poor the overall situation is; for example:

a. One ship Commanding Officer reported that he considers improvement has been made in shipyard productivity aboard his ship. However, in the same report he stated that 25 out of 42 shipyard workers observed by him in a recent tour through his ship were idle.

b. In another yard, Commanding Officers of the submarines present in the yard reported 12 to 38 percent of the workers on board their ships were observed to be not working. The yard reacted by congratulating the workers on the ship with only 12 percent lack of productivity.

10. Approximately 14 people in one yard were observed by a ship's Executive Officer lined up in a compartment of the ship waiting for an electrician, who was blocking the passageway, to complete a lengthy job. The Executive Officer had to intercede with a yard supervisor before the electrician would move aside to let the people past so they could proceed to their assigned work.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO

2 7 MAR 1972

Mr. L. C. Ackerman, President
Newport News Shipbuilding and
Dry Dock Company
Newport News, Virginia 23607

Dear Mr. Ackerman:

I have just read the speech on Government contracting given to the Federal Government Accountants Association, Virginia Peninsula Chapter, on March 15, 1972 by your vice president for contracts, and the news article reporting the speech in the Newport News Times Herald.

Your vice president, of course, is completely free to express any views he wishes. But if he really believes that high costs, excessive profits, cost overruns, and contractor abuses on defense contracts are "myths," and that those of us who are concerned about these matters are "lazy-minded" and "demagogues," then I believe you have a serious problem.

There has been ample testimony in recent years demonstrating that defense procurement problems are hardly mythical. Former Secretary Packard spoke out on several aspects of what he called the "mess" in defense procurement. I, too, have testified concerning numerous specific aspects of the problem. Findings of the Commission on Government procurement, the Blue Ribbon Defense Panel, the General Accounting Office, and various Congressional investigations, as well as literally hundreds of thousands of pages of hearings before various Congressional committees attest to the problems in defense procurement today.

To label these problems "myths" — "created and nurtured by those who seek headlines and publicity at the expense of truth" -- does little good for Newport News or the defense industry generally. Such statements contribute to public mistrust and enlarge the credibility gap between the public and the defense industry.

In connection with our nuclear shipbuilding programs, I have tried to ferret out the problems in contracting for nuclear warships and face up to them. I have done so to avoid the pitfalls that have plagued other defense programs. However, I found that not all the cockroaches came from the apartment next door. With respect to shipbuilding programs, for example, I found:

- Inadequate cost controls
- Poor procurement practices
- Excessive progress payments
- Denial of records to Government auditors
- Mischarging of labor costs
- Deficiencies in material control systems

- Excessive charges in overhead accounts
- Excessive profits
- Excessive loafing and idleness
- Excessive use of overtime
- Inadequate Government surveillance of shipbuilding contracts

Not all these problems occurred at Newport News. However, a sufficiently high percentage of them exist at your yard to provide solid evidence that greater management attention to Navy shipbuilding work is needed at Newport News.

Since nuclear powered ships constitute the bulk of Newport News' work, I can only assume that your vice president's statements were directed, at least in part, to me. I would like to know if his speech was approved by Newport News management. I would also like to receive, at your earliest convenience, specific details of cases where, in my dealings with Newport News, I have been lazy-minded, demagogic, or inaccurate. Unless your official can substantiate such statements I feel he owes an apology to his audience as well as to me.

In our years of working together, I have felt free to give you suggestions on improving work at Newport News. I believed you also felt free to suggest improvements on the Navy's side. You can understand, therefore, why I am disturbed by your official's allegations.

It is my belief that the Department of Defense and the defense industry are going to have to make a real effort to put defense procurement on a more efficient basis. This means improvement of Department of Defense procurement policies and procedures and improved administration of our contracts. It also means the defense industry is going to have to set its own house in order. There are plenty of problem areas at Newport News that need the attention of your management personnel. Additional effort in these areas -- including contracting -- would be far more beneficial for Newport News, for the defense industry generally, and for the United States than efforts to label these problems as myths.

In order that the relationship between your customer and Newport News may continue in a frank and open manner I would appreciate a reply at your earliest convenience.

Yours very truly,

H. G. Rickover

H. G. Rickover

Copy to:
Commander, Naval Ship Systems Command

President, FGAA
Virginia Peninsula Chapter
Newport News, Virginia

NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY
NEWPORT NEWS, VIRGINIA 23607

L. C. ACKERMAN
PRESIDENT AND CHIEF EXECUTIVE OFFICER

April 26, 1972

Vice Admiral H. G. Rickover, USN
NAVSHIPS 08
Naval Ship Systems Command Headquarters
Department of the Navy
Washington, D. C. 20360

Dear Admiral Rickover:

Thank you for your frank and open letter of 27 March 1972.

This is to advise you that in view of this we are establishing a review procedure with regard to public statements by shipyard officials wherever they deal with our relationships with our principal customers.

Sincerely yours,

L C Ackerman

UNITED STATES
ATOMIC ENERGY COMMISSION
WASHINGTON, D.C. 20545

MAR 31 1972

Mr. William B. Petty
Director, Defense Contract Audit Agency
Cameron Station
Alexandria, Virginia 22314

Dear Mr. Petty:

I know of your commitment to provide an effective audit service for defense programs. Based on my recent experiences at two major shipyards, I wish to inform you of areas where I think the Defense Contract Audit Agency (DCAA) can make substantial improvements in its audit coverage.

For several years I have been looking into the procurement, cost control, and financial management practices at Electric Boat Division, General Dynamics Corporation and at Newport News Shipbuilding and Dry Dock Company, a division of Tenneco, Inc. My concern stems from the rapidly increasing shipbuilding costs which, in turn, jeopardize congressional support for Navy shipbuilding programs.

I assigned a representative at each shipyard to see how the Navy's shipbuilding work was being handled. Attachment A shows reports resulting from this effort. They highlight many serious deficiencies and recommend corrective action. Here are some of the deficiencies we have found and reported:

a. Procurement practices. Neither shipyard had implemented the Truth-in-Negotiations Act some six years after enactment by Congress. Procurement files were not properly documented. Procurement personnel were not well versed in cost and price analysis. There was little or no evidence of meaningful price negotiations. There were inadequate safeguards over supplier bid information.

b. Cost control. Neither shipyard had effective cost control or cost reporting systems. Potential overruns could not be anticipated with any degree of precision because costs could not be related to progress. There were no effective budgets for material procurements. At one shipyard, it was possible to meet all working level budgets and still overrun the contract price.

c. Progress payments. Through progress payments, the government was paying shipbuilders substantially more than needed to finance the contract; in effect the shipbuilders were getting an interest-free advance of government funds. Shipbuilders were paid for material before the shipbuilder paid the supplier and before it was actually issued for use. Contractor employees were offered cash awards for suggesting ways to increase the amount of costs that could be charged to the government under progress payments. One shipyard got government representatives to approve a method of calculating and certifying costs for progress payments such that the shipbuilder was able to collect twice for escalation.

d. Access to records. The government did not have access to shipbuilder books and records necessary to determine the reasonableness of charges to government contracts. Government representatives were denied access to cash flow information, capital investment plans and decisions, and labor budgets.

e. Material costs. One shipbuilder's material control system was deficient to the extent that it was not possible to determine the reasonableness of charges to Navy contracts. A government auditor discovered many of these deficiencies more than four years ago but they were not officially reported by DCAA until recently.

f. Flexible cost charging practices. Flexible cost charging practices resulted in cost-type contracts bearing a disproportionate share of shipyard costs. The wages of personnel in the salvage department were charged as a direct cost to cost-type contracts but as overhead on fixed-priced work. Storage areas were also charged this way. It appeared that the method in which costs were charged was dependent on the type of contract involved.

g. Direct labor controls. Controls over direct labor charging practices were inadequate. The government auditor initially denied this, but, after a more thorough check, he found a high error rate in cost charges.

h. Overhaul and conversion work. Polaris submarine overhaul and conversion work costs about 30 percent more at Electric Boat than at Newport News. Yet the higher cost shipyard, Electric Boat, got substantially more profit than Newport News for each submarine overhauled. The Government auditors had not raised this issue, nor had they investigated what caused the higher costs at Electric Boat.

Here is what I conclude:

a. In general, your auditors lack perspective in their work. No doubt they are intelligent and conscientious people, but most of their time appears to be spent reviewing contractor proposals, checking rate computations, and performing other routine work. Not enough effort is directed toward evaluating how well the contractor controls his costs, or manages his business. Had such reviews been conducted, the auditors would have discovered and reported at least some of the more basic problems years ago — the lack of effective cost control systems at the shipyards, the access to records problem, the gross disparity in overhaul costs at the two shipyards, the fact that the Navy paid substantially more profit to the higher cost shipyard, and so on.

b. Auditors frequently take too narrow a view of their responsibilities. Take overhead costs: Supervisors of Shipbuilding paid little attention to overhead costs, apparently thinking that audit verification of overhead rates was enough. The auditors, however, only checked the rate calculations and the allowability and allocability of the overhead costs. They counted on the Supervisors of Shipbuilding to determine whether overhead costs could be reduced by better management. Thus, no one was really checking the reasonableness of overhead costs; yet this fact apparently went unnoticed and unreported by the auditors.

c. The government auditors sometimes are reluctant to insist upon obtaining the records they need. For example, until recently, the auditors at one shipyard were willing to do without contractor cash flow data, capital investment plans, labor budgets, and profit data because the shipbuilder did not want to reveal such data. A recent report of a DCAA meeting in Washington states that DCAA will not exchange financial and performance data among government audit offices at shipyards doing similar work for fear that a contractor's proprietary data might be compromised. Yet by doing without such data, auditors are handicapped in their ability to evaluate contractor performance and highlight potential problem areas.

d. The auditors seem reluctant to require contractors to demonstrate that the shipyards are being run efficiently and economically. Neither Electric Boat nor Newport News yet has an effective internal audit program geared to systematic reviews of each operation to see that performance is efficient and economical. The shipyard's cost control systems are also inadequate. Had the auditors required shipbuilders to demonstrate the adequacy of their cost reporting and internal auditing systems, these problems would have been recognized and reported much earlier than 1969 when I first raised these issues.

e. The auditors have been reluctant to question government operations. For years, the government auditors went along with the Navy and its so-called disengagement policy — the idea that you could trust shipbuilders to make business decisions that would be in the public interest without close government surveillance. As it turned out, the Department of Defense had never sanctioned such a policy and the Navy subsequently repudiated it.

f. DCAA auditors deal at too low a level. The head resident auditor at each shipyard should meet regularly with the head of the shipyard to discuss deficiencies and raise issues that are not being resolved adequately at lower levels. This should also be done at other activities.

The answer to more effective government surveillance is not more auditors. Even one or two people with proper direction and management support can go a long way toward uncovering problems and focusing attention on the corrective action needed. What is needed, as I see it, is closer involvement in the day to day audit operations by DCAA headquarters. Experience has amply shown that we cannot afford to leave auditing completely to the discretion of the local offices.

An effective government audit and surveillance program is, in my view, essential to a strong national defense. I will be glad to help you in your efforts to correct the situation. Please let me know of any additional information needed. I would appreciate being informed of what actions are taken in this matter.

Sincerely,

H. G. Rickover

Copy to:
Assistant Secretary of Defense (Comptroller)
Assistant Secretary of the Navy (Financial Management)
Chief of Naval Material
Commander, Naval Ship Systems Command

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-1337, dated 30 April 1969, Subject: Review of Controls over Construction Costs of Nuclear-Powered Ships at Newport News Shipbuilding and Dry Dock Company

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), dated 13 September 1969, Subject: Procurement Practices and Cost Control under Navy Contracts with Electric Boat Division, General Dynamics Corporation, for Design, Construction, and Overhaul of Nuclear Submarines

- My memorandum for the Commander, Naval Ship Systems Command, Serial 08H-01354, dated 23 September 1969, Subject: Cost Controls at Newport News Shipbuilding and Dry Dock Company

- My memorandum for the Commander, Naval Ship Systems Command, Serial 08H-714, dated 16 February 1970, Subject: Control of Ship Construction Costs at Newport News Shipbuilding and Dry Dock Company

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-718, dated 19 February 1970, Subject: Procurement Practices and Cost Control under Navy Contracts with Electric Boat Division, General Dynamics Corporation, for Design, Construction, and Overhaul of Nuclear Submarines

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-767, dated 15 July 1970, Subject: Review of Overhead Costs on Navy Contracts at Electric Boat

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-772, dated 26 August 1970, Subject: Deficiencies in Procurement and Cost Control Practices of the Electric Boat Division, General Dynamics Corporation; comments on NAVSHIPS Investigation of

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-786, dated 30 October 1970, Subject: Excessive Shipbuilder Profits on Nuclear Submarine Overhaul and Conversion Contracts

- My memorandum for the Commander, Naval Ship Systems Command, Serial 08H-1438, dated 14 April 1971, Subject: Deficiencies in the Procurement of Nickel Alloy Materials by Newport News Shipbuilding and Dry Dock Company

- My memorandum for the Commander, Naval Ship Systems Command, Serial 08H-1468, dated 4 June 1971, Subject: Need for Improved Controls over Change Order Pricing at the General Dynamics Corporation's Electric Boat Division

- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-1478, dated 14 July 1971, Subject: Excessive Progress Payments on Nuclear Shipbuilding Contracts at Newport News Shipbuilding and Dry Dock Company

ATTACHMENT A

- My memorandum for the Commander, Naval Ship Systems Command, Serial 08H-1495, dated 18 September 1971, Subject: Excessive Costs of Nuclear Submarine Overhaul and Conversion Contracts at Electric Boat
- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-1496, dated 2 October 1971, Subject: Progress Payments on Nuclear Shipbuilding Contracts
- My memorandum for the Deputy Comptroller of the Navy, Serial 08H-1515, dated 15 November 1971, Subject: Progress Payments on Newport News Shipbuilding Contracts
- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), Serial 08H-518, dated 28 February 1972, Subject: Progress Payments on Nuclear Shipbuilding Contracts
- My memorandum for the Assistant Secretary of the Navy (Installations and Logistics), dated 27 March 1972, Subject: Progress Payments on Navy Shipbuilding Contracts

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO

CA-D

April 7, 1972

Vice Admiral H. G. Rickover
Deputy Commander
Nuclear Power Directorate
Naval Ship Systems Command (Code 08)
Navy Department
Washington, D. C. 20360

Dear Admiral Rickover:

This will acknowledge receipt of your letter of March 31, 1972, in which you discuss various problems and deficiencies which you have noted in your own surveillance of Defense contractors, with particular reference to certain major shipyards.

I consider your letter to be most constructive and you may be assured that we will move out very promptly in the effort to effect improvements in those areas for which we are responsible and over which we can exercise some control. We will be in touch with you and your staff quite soon for this purpose.

Sincerely,

William B. Petty
Director

DEFENSE CONTRACT AUDIT AGENCY
CAMERON STATION
ALEXANDRIA, VIRGINIA 22314

IN REPLY REFER TO

CA-D

April 7, 1972

MEMORANDUM FOR REGIONAL MANAGERS, DCAA
RESIDENT AUDITORS, DCAA
BRANCH MANAGERS, DCAA

SUBJECT: Attached Letter from Vice Admiral H. G. Rickover

Your careful and thoughtful attention is directed to the attachment, and most particularly his observations about how he believes that we in DCAA could do our job better. His initial emphasis is on shipyard work, but it strikes me that his comments may be equally pertinent elsewhere. Therefore, with his permission, I am sending a complete copy of his letter to you.

Many of the deficiencies and weaknesses which Admiral Rickover writes about are the same that we have tried to overcome and correct in our operational surveys and reports. We certainly can join with him in the effort to accomplish needed and often long overdue improvements. If, as he believes, we have been too passive and too willing to accept conditions as they exist, I would like for us to be more aggressive wherever there is a need to be so.

We will soon meet with Admiral Rickover and his staff to discuss matters relating to the particular shipyards to which he makes reference, and the Office of the Deputy for Audit Management will pursue these subjects with the Regional Managers and the Resident Auditors who are concerned.

William B. Petty
Director

Enclosure

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-535
28 April 1972

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS)

Subj: Progress Payments under Navy Shipbuilding Contracts

Encl: (1) Report of Meeting with Representatives of the Offices of the Assistant Secretary of the Navy (Installations and Logistics) and the Assistant Secretary of the Navy (Financial Management) on April 14, 1972

1. Thank you for your 21 April 1972 memorandum regarding progress payments under shipbuilding contracts. The recent Naval Material Command policy directive which requires the elimination of unallowable costs from cost-based progress payments (NAVMATNOTE dated 6 April 1972) appears to resolve the issue I raised in my February 28, and March 27, 1972 memoranda to you.

2. Your 21 April memorandum also makes reference to a recent meeting among representatives of our staffs and the staff of the Assistant Secretary of the Navy (Financial Management). Enclosure (1) is a report sent to me following that meeting by Mr. Greer of my office.

3. In his report, Mr. Greer expresses concern that many of the shipyard problems I have been reporting to you and to others are not being given adequate consideration by senior members of your staff nor by the staff of the Assistant Secretary of the Navy (Financial Management). Mr. Greer's report states that he was urged by the ASN(I&L) and ASN(FM) representatives to raise shipbuilding issues at the staff level rather than through the medium of memoranda to you and other senior naval officials, in order to avoid "sending ripples through the Navy." Mr. Greer's report also states that the ASN(I&L) and ASN(FM) representatives believe that much more has been accomplished toward correcting the shipbuilding problems than either he or I believe to be the case.

4. The tendency of devoted staff members to "protect" their superiors from unpleasant news is a common practice; it has been so throughout history. But this tendency must be overcome if we are to correct the many longstanding and difficult problems at our shipyards and other activities. Correction of these

problems will continue to require your personal attention and action since these problems affect the Navy's ability to get the ships it needs at reasonable cost. Without your personal involvement and that of your predecessors, we would not yet have realized the improvements that have been made to date.

5. For the above reasons, I will continue to raise directly with you and other superiors those matters that I consider warrant your personal attention.

6. I am sending this memorandum to you and to the Assistant Secretary of the Navy (Financial Management) for your personal information. No response is necessary.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Financial Management)

DEPARTMENT OF THE NAVY

Memorandum

DATE April 17, 1972

FROM M. C. Greer

TO VADM H. G. Rickover

SUBJ MEETING WITH REPRESENTATIVES OF THE OFFICE OF THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS) AND THE OFFICE OF THE COMPTROLLER OF THE NAVY on April 14, 1972, RELATING TO PROGRESS PAYMENTS ON NAVY SHIPBUILDING CONTRACTS AND OTHER PROBLEMS

1. The purpose of this memorandum is to relate the substance of a meeting in my office on April 14, 1972 among myself, Mr. T. L. Foster and the following representatives from the Office of the Assistant Secretary of the Navy (Installation and Logistics) and the Office of the Comptroller of the Navy (NAVCOMPT):

Mr. J. T. Gallagher - ASN(I&L) Staff
Mr. L. E. Chermak - Counsel, NAVCOMPT
Mr. C. A. Buehrle - Director Banking and Contract Financing, NAVCOMPT

2. This meeting was requested by Mr. Gallagher about two weeks ago. His request grew out of the recent exchange of correspondence between you and the ASN(I&L) regarding payment of unallowable costs in progress payments under shipbuilding contracts. The background for this meeting is summarized below:

a. On February 28, 1972 you wrote to the ASN(I&L) pointing out that the Navy is financing unallowable costs through progress payments on fixed price type shipbuilding contracts with Newport News and other shipyards. You recommended that the Navy issue instructions requiring the elimination of unallowable costs from progress payments.

b. On March 23, 1972 the ASN(I&L) responded to the effect that:

(1) Your February 28 memorandum overstated the amount of unallowable costs at Newport News through omission of certain credits;

(2) The interest on the overpayments would not have exceeded $2,500.

(3) Prior to your memorandum the Supervisor of Shipbuilding had made an analysis of unallowable costs included in progress payment vouchers and the review indicated that no unallowable costs had been paid since September 1970;

(4) The Supervisor of Shipbuilding, Newport News had instituted procedures to preclude payments not based on proper accounting procedures.

By copy of his memorandum, the ASN(I&L) requested the Chief of Naval Material "to monitor the shipbuilding program and to keep me advised of any inadequate administration of progress payments which may occur." The ASN(I&L) memorandum was, I believe, drafted by Mr. Gallagher and Mr. Chermak.

c. On 27 March 1972 you again wrote the ASN(I&L) pointing out that:

(1) The sum and substance of your February 28 memorandum was not a mere $2,500 matter;

(2) Changes in the Newport News accounting procedure had the effect of reducing but not eliminating disallowances;

(3) The Supervisor of Shipbuilding's review was after you raised the issue, not before;

(4) Payments which included unallowable costs had been made to Newport News much later than the 30 September 1970 date quoted by ASN(I&L)

(5) The credits mentioned in the auditor's report did not affect the amount of cost disallowances.

(6) The Navy should issue specific instructions that would eliminate unallowable costs from progress payments as you had previously recommended.

d. On April 6, 1972 the Chief of Naval Material issued a directive (NAVMATNOTE 4200 of 6 April 1972) to require the elimination of unallowable costs from progress payments, as you proposed.

Copies of the above correspondence are attached.

3. The main point I hoped to make in meeting with Mr. Gallagher was that it is difficult to try to improve the administration of Navy shipbuilding contracts when the problems are not taken seriously by top Navy procurement officials. I planned to review with him some of the shipyard problems we have reported over the past four years, and to point out that:

a. Inevitably the responses to issues we have raised were prepared by people who were responsible organizationally for the problem area and who therefore tended to downplay the issue.

b. The responses tended to focus attention on the examples cited rather than the principles involved. Generally, this was done by taking issue with the facts cited in the example.

c. The responses always cited improvements that were in process.

d. The responses often sought to close out the issues without appropriate corrective action.

I wanted to show Mr. Gallagher the parallel between these responses and the ASN(I&L) response to your February 28 memorandum.

4. The meeting did not go as I had hoped it would. It became apparent to me that the purpose of the meeting from Mr. Gallagher and Mr. Chermak's standpoint was to discourage further "Rickover memoranda" because they "send ripples throughout the Navy" and make a lot of extra (and presumably unnecessary) work. Both Mr. Gallagher and Mr. Chermak said I should call them regarding our problems since I am not always in a position to know what is going on in Navy policy circles.

5. Mr. Gallagher was particularly disturbed by your March 27, 1972 memorandum. He said you accused the Navy of doing nothing to improve the administration of progress payments when in fact he thought quite a bit was being done. He and Mr. Chermak both felt that your memoranda ignored the work of the NAVCOMPT Progress Payment Task Group. (In fact you did not, you pointed out that progress was being made). Mr. Gallagher also claimed that the NAVMAT directive eliminating unallowable costs from progress payments was the direct result of the ASN(I&L) March 23, 1972 response to you. He said that the ASN(I&L) response made no promise to issue such a directive because he, Mr. Gallagher, could not be sure how long it would take NAVMAT to issue the instruction.

6. I told Mr. Gallagher that the ASN(I&L) March 23 memorandum could be read only one way -- as a turndown of your recommendation and a "close-out" of the issue. There was nothing in that

memorandum to indicate that the Navy agreed with your recommendation and intended to implement it. Moreover, I showed Mr. Gallagher that your memorandum did not say that the Navy wasn't doing anything; it merely disagreed with the Assistant Secretary's apparent decision to do nothing further with regard to your specific recommendation, i.e., to issue instructions requiring the elimination of unallowable costs from progress payments. I acknowledged that NAVMAT subsequently issued the directive you had recommended and that the NAVCOMPT Progress Payments Task Group now seems to be doing a good job.

7. Mr. Gallagher appeared to want some way to close out the unallowable-cost-in-progress-payments issue without having to write another letter for the ASN(I&L) He asked me to write a letter to state that you were satisfied with the actions taken by ASN(I&L). I refused. However, I told him that as far as you are concerned the issue is settled since NAVMAT has now taken the action you recommended.

8. During the meeting, I spent quite some time reviewing the issues we had raised in the past. I was not at all encouraged, however, by the response; for example:

a. I mentioned the lack of effective cost control at Newport News. Mr. Gallagher said things were now much better at Newport News, alluding to their new "space control" cost system. I told him that the new system affects only about 15% of ship costs and that it had not yet been implemented on the test ship -- the DLGN 38.

b. I mentioned the lack of effective budgetary controls over material costs. Mr. Gallagher argued emphatically -- even offered to bet me -- that Newport News and Electric Boat in fact had such controls. We showed him the minutes from a March 23, 1972 cost control meeting with Electric Boat representatives wherein Electric Boat stated that their present system does not show whether the orders they place are contributing to a potential cost overrun or cost underrun.

c. I mentioned the case of Electric Boat charging off inventories at the end of the month for progress payment purposes and later reversing the charge so the government ends up financing the inventory. Mr. Chermak seemed to be of the opinion that it did not really matter since the inventories would eventually be used on Navy work. He indicated that most knowledgeable people in the business knew that under the special progress payment provisions on shipbuilding contracts the Navy ends up financing nearly all costs at the shipyards. I pointed out to him that this procedure results in unnecessary cost to the government.

d. I mentioned the problem of drydocking costs at Electric Boat being about five times more than at Newport News, principally because of the difference in methods of depreciation used and in the depreciable lives established for the dry docks. Mr. Chermak stated that ASPR rules provide that the Department of Defense will accept whatever the Internal Revenue Service accepts so the Navy's hands are effectively tied. I told him that I thought the Navy itself should have a say in determining what depreciation is appropriate for drydocks servicing only Navy ships.

In short, neither Mr. Gallagher nor Mr. Chermak seemed to take the issues I was raising seriously; they disagreed with most of them.

9. Upon reflection, a number of things disturb me about the meeting:

a. Senior representatives of the offices of ASN(I&L) and NAVCOMPT apparently do not view the issues you are raising as particularly serious matters warranting top level attention in the Navy. Rather they seem to feel that these issues can be handled routinely by existing organizations.

b. They wanted me to bring future shipyard problems to them. Yet, Mr. Gallagher, in particular, and Mr. Chermak, to a lesser extent, reacted negatively to most of the problems you have raised. In general, they indicated that we tend to generalize from one or two examples, and that the Navy deserves more credit than we give it.

c. Mr. Gallagher regularly visits shipyards on procurement review teams and other special projects, and is influential in Navy procurement. He paints a picture of substantial improvement in shipyard practices. This conflicts with your view and my view that not much has been accomplished in correcting the deficiencies you have identified.

d. Mr. Gallagher implied that both Mr. Annan's and LCDR Ledwig's reports are unreliable. He claims they take examples out of context and blow them into big issues. He seemed to remain firm in this conviction although the record clearly shows that Annan and Ledwig have been right in virtually all respects. For example, after Ledwig raised the issue of inadequate controls over materials at Electric Boat, both the Supervisor of Shipbuilding and NAVSHIPS' Special Review Team took issue with him. Later, the DCAA auditor confirmed Ledwig's findings and refused to certify Electric Boat's accounting for material costs. Again, Navy officials took issue with Annan's report that Newport News did not have an effective cost control system. The Assistant Secretary of Navy (Financial Management) ultimately formed a special study group to review the Newport News cost control system; that group confirmed that Annan was right. This has been the case time and time again.

e. Mr. Gallagher and Mr. Chermak thought you had not given the Navy enough credit for Navy efforts to improve cost control, progress payments, shipbuilder procurement practices, contract administration, and the like. They seemed to ignore the fact that these efforts all stemmed directly from reports you have issued to your superiors. Prior to that, the Navy had done little in these areas.

10. Based on this meeting, I will make an effort to work more closely with these officials to make sure they are truly aware of the problems we find. However, from this meeting I am even more concerned that senior Navy procurement officials are not getting an accurate view of shipyard problems. Therefore, while it may offend some staff members, my conclusion is that you should continue to raise these shipyard issues via formal memoranda with the responsible officials just as you have in the past.

M. C. Greer

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-546
18 July 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Excessive Prices for Changes to NAVSHIPS Contracts at Litton Industries' Ingalls Nuclear Shipbuilding Division, Pascagoula, Mississippi

Encl: (1) My ltr dtd 15 May 1972 to Supervisor of Shipbuilding, Pascagoula
(2) Supervisor of Shipbuilding, Pascagoula, ltr Ser 100-14 dtd 31 May 1972
(3) My ltr dtd 27 Jun 1972 to Supervisor of Shipbuilding, Pascagoula

1. Attached as enclosures (1) through (3) are copies of correspondence between the Supervisor of Shipbuilding, Conversion and Repair, Pascagoula and myself. This correspondence identifies deficiencies in pricing of contract change orders at Ingalls and indicates that the Navy may be paying excessive prices, possibly as much as a factor of two, for changes to submarine overhaul contracts. It also indicates that there may be substantial errors in Ingalls' labor charges on Navy contracts.

2. Based on enclosures (1) through (3) and other facts, I believe that NAVSHIPS should initiate a thorough investigation into the pricing of contract changes by SUPSHIPS Pascagoula. Specifically:

a. The cost of change orders on the overhaul of the SSN's 612 and 614, at Ingalls, was 32% and 27% of the original contract target costs respectively. These figures far exceed the percentages for changes at other private yards doing nuclear submarine overhauls.

b. A comparison of the cost per ship for the same Headquarters Modification Requests (HMR's) invoked on new construction ships at Electric Boat (SSN's 678/679/681/684) and Ingalls (SSN's 680/682/683) reveals that costs at Ingalls are 60% higher than at Electric Boat. In some cases, the negotiated prices for Ingalls' changes have been four times the price for similar work at Electric Boat.

c. The profit percentages allowed by SUPSHIPS Pascagoula on change orders for SSN's 680/682/683 average 16% of cost, which is excessive. The original contract target fee was 6.94% of cost.

3. I recommend that NAVSHIPS investigate the pricing of contract changes and labor charging practices at Ingalls. I also recommend that the pricing of change orders by the Supervisors of Shipbuilding at other private yards be reviewed to determine whether problems similar to those identified at Pascagoula exist. I would appreciate being advised of the action taken in this matter.

H. G. Rickover

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON D.C. 20360

15 May 1972

RADM C. N. Payne
Supervisor of Shipbuilding,
Conversion and Repair
Pascagoula, Mississippi 39567

Dear Admiral Payne:

Enclosed is a copy of a memorandum sent to me by my representative in Pascagoula. He reports that he had expressed to you his concern for the amount of the Ingalls claim for rewinding the pressurizer heater cables in USS GREENLING (SSN 614). He states that he pointed out to you on 3 April that the claim appeared excessive, that he was reviewing it, and that he would get back to you with his comments. Subsequently and prior to receiving any comments on the claim from my representative, you approved the change order at 97% of the contractor's claim.

Enclosure (1) states that this settlement appears excessive in relation to the work actually performed by Ingalls. I would appreciate your looking into this matter at your earliest convenience and giving me your comments. I would like to know:

a. Do the facts related in my representative's memorandum correctly reflect the amount of work performed by Ingalls? If so, on what basis did the Supervisor approve the contract change for several times the amount due Ingalls?

b. If the facts are not correct, what was the basis for the settlement of the change order?

c. Why was the change settled before receiving comments from my representative, after he had expressed his concern to you?

I would appreciate a prompt response.

H. G. R
H. G. RICKOVER

Encl:
(1) Memorandum from P. D. Rice to
VADM Rickover of 10 May 1972

bcc: P. D. Rice, w/o encl.

OPNAV 5216/144 (REV. 6-70)
S/N 0107-776-6099
DEPARTMENT OF THE NAVY

Memorandum

DATE: 10 May 1972

FROM P. D. Rice, PNROR, Pascagoula

TO VADM H. G. Rickover

SUBJ Excessive Cost of USS GREENLING (SSN614) Pressurizer Heater Cables Repair Work

1. In February 1972, a problem developed during post overhaul sea trials in USS GREENLING concerning insulation resistance deficiencies in three pressurizer heater electrical junction panels in the ship's reactor compartment. Subsequently, COMSUBLANT approved correcting these deficiencies and, in order to prevent delay in the delivery of the ship, the Supervisor of Shipbuilding issued a unilateral change to Ingalls to perform this work. All repairs were accomplished by the yard during a one week period ending February 23, 1972, and involved installing new insulating sleeves and terminal lugs on 472 electrical leads.

2. On 20 March 1972, Ingalls submitted to the Supervisor of Shipbuilding a change order for the work discussed above. Ingalls' proposed increase in price was $18,398 including a total charge for material of $258. On 3 April 1972, I pointed out to the Supervisor of Shipbuilding (Admiral Payne) that Ingalls' proposed change order appeared to be excessive and that I was reviewing the Ingalls claim and would get back to him on any points which I found that could assist Payne in the evaluation and negotiation of the change order. However, on 13 April 1972, prior to completion of my review, the Supervisor's office approved Ingalls' change order for the pressurizer heater cable repairs at an increase in price of $17,780 (97% of Ingalls' request).

3. Based on the following comments, which outline the results of my review of this Ingalls change order, I am concerned that the Supervisor of Shipbuilding may be approving Ingalls' change order proposals without an adequate review to determine whether their claims are accurate, properly justified, and do not result in excessive charges to the Government:

(a) The Ingalls change order states that 748 man-hours of electrical craft time, excluding supervision, were used to perform the work directly involved at the electrical panels in the reactor compartment, and an operational test subsequent to the work. However, Ingalls' records for access to the reactor compartment where nearly all of this work was performed show that electrical craft personnel spent only about 230 man-hours at the work site. This actual recorded work time, plus about eight additional man-hours which I estimate as the maximum time required for the operational test, is less than one-third of the 748 man-hours claimed for this portion of Ingalls change order. This does not include shop work and administrative efforts which are claimed separately in the Ingalls change order.

(b) The Ingalls change order shows that 144 man-hours of electrical supervision were charged for this job. However, Ingalls' reactor compartment access records show that a total of only nine of the 144 man-hours charged (6%) were actually spent at the work site by electrical supervisors. Supervisory and support personnel such as nuclear inspectors discussed below probably would not spend full time at the work site since the site is a radiation area. However, it stands to reason that personnel used only on a limited basis for this specific job would also be used for other overhaul or new construction submarine work, especially in light of Ingalls' claim in a separate section of the Ingalls change order for disruption of workers, including electrical supervisors and nuclear inspectors.

(c) The Ingalls change order claims that 196 man-hours of Nuclear Quality Assurance personnel time were used to inspect the insulation work, temporary shielding installation, and post repair operational test. However, based on Ingalls' records only about 13% of this time was spent in the reactor compartment where the work was performed. Based on the above and my estimat of the inspection effort required for the operational test, it appears that less than one-third of Ingalls' claim for this area is valid.

(d) As stated in comment (c), the Ingalls change order shows that part of the Nuclear Quality Assurance personnel man-hours claimed was to inspect the temporary shielding installations. However, Ingalls' procedures do not require temporary shielding installations to be inspected by nuclear inspectors. Based on my discussion with Ingalls' Manager of Nuclear Quality Assurance, no such inspection by Nuclear Quality Assurance personnel was performed.

(e) The Ingalls change order states that 144 hours of premium time were required for Electrical Department personnel on the weekend which occurred during the time period for this job. This claim is based on 12 men working 8 hour shifts both on Saturday and Sunday. However, my review shows that Ingalls' claim is inflated by at least a factor of two since Ingalls reactor compartment access records show that less than six equivalent full-time electrical personnel were actually working at the work site on Saturday and Sunday.

(f) The Ingalls change order states that 104 man-hours of Radiological Engineering personnel time were required for the design and engineering effo associated with temporary lead shielding for this job. My review shows that this estimate is grossly overstated based on the simple nature of the temporary shielding involved and based on the fact that Ingalls' reactor compartment access records show that less than one man-hour was spent at the work site by Radiological Engineering personnel.

(g) The Ingalls change order states that 12 man-hours were required by Nuclear Quality Engineering personnel to evaluate the test results. This effort simply involved checking approximately 100 electrical resistance measurements to see if these data were within acceptable limits. My estimat of the time required for this work is less than one hour.

4. This change order has resulted in a direct increase in the target cost of the USS GREENLING overhaul contract. I have not determined the actual cost Ingalls has charged to the contract. However, the work was completed well be the proposal was submitted to the Supervisor's office. I intended to bring t matter to the attention of the Supervisor of Shipbuilding and to request that the Supervisor obtain a price reduction from Ingalls based on the yard's reco showing actual work times spent on the job. However, considering the discrepancies and inconsistencies in the pricing of this relatively inexpensive char order, I feel the implications are such that you may wish to bring this matte to the attention of higher Navy officials.

cc: M. C. Greer

SUPERVISOR OF SHIPBUILDING, CONVERSION
AND REPAIR, U. S. NAVY
PASCAGOULA, MISSISSIPPI 39567

100:CNP:mlw
Ser: 100-14
31 May 1972

Vice Admiral H. G. Rickover, USN
Naval Ship Systems Command (08)
Department of the Navy
Washington, D. C. 20360

Dear Admiral Rickover:

This is in reply to your letter of 15 May, 1972 regarding the settlement of Ingalls' claim for repairing the pressurizer heater cables in USS GREENLING (SSN614). In that letter you asked three questions, which are given in the following with my answers to each.

The first question was "Do the facts related in my representative's memorandum correctly reflect the amount of work performed by Ingalls? If so, on what basis did the Supervisor approve the contract change for several times the amount due Ingalls?" The facts stated by Mr. Rice are substantially correct. However, detailed investigation of man-hour charges indicate that his conclusions drawn from these facts may not be fully accurate. Details are provided in Enclosure (1). In summary, Ingalls did submit a proposal which included the following estimates (not stated to be return costs). These are given together in the below table with now available return costs which have been examined by my staff and are in conformity with regular cost accounting practices of Ingalls which have been approved by DCAA.

	Ingalls Proposal	Negotiated Estimates	Return Costs
Electrical Craft	748 M.H.	706 M.H.	609 M.H.
Electrical Supervision	144	136	112
Nuclear Q.A.	202	202	156
Radiological Control	164	164	172
Other *	388	377	376
Total	1646	1585	1425
Cost	$16,741	$16,177	$14,490
Fee	1,657	1,602	1,435
Total	$18,398	$17,779	$15,925

ENCLOSUR

*Assist trades, temp. ventilation, disruption, radiological engr., etc.

100:CNP:mlw
Ser: 100-14
31 May 1972

Your second question was "If the facts are not correct, what was the basis for the settlement of the change order?" Recognizing that the third column "Return Costs" was not available at the time of the settlement, my negotiators were concerned with the fact that this was unplanned work, identified during Fast Cruise and accomplished between First and Second Sea Trials. Due to the overrun condition of the contract, they were anxious to adjudicate all open changes in order to prevent possible resubmission of proposals that included delay and additional disruption. The thrust from my office had been to force Ingalls to thoroughly plan this work and accelerate as much as possible. The Navy negotiators were also mindful of the fact that only the actual costs (third column) would be charged finally to the Government under the cost-plus-incentive-fee type contract. The basis actually used was the Price Analysis technique provided for in SACAM for cost contract modifications in this dollar value category.

Your third question was "Why was the change order settled before receiving comments from my representative, after he had expressed his concern to you?" My records show that Mr. Rice called this matter to my attention on the afternoon of 30 April. I did not pass on to my staff any constraints as a result of this information (as I should have done, and normally would have done) partially due, I think to my preoccupation with events in a very heavy schedule during the few days immediately following, including a full day visit by the Australian CNO (West Bank), a visit by Congressman Kyros (West Bank), several conferences concerning certification of the Ingalls dry dock, and its potential ramifications on the schedule of GATO. In addition on April 4, and the following few days, I changed my residence to a new address. I therefore take full responsibility for the failure to instruct my staff to await Mr. Rice's analysis before proceeding with negotiations.

In this regard, it is my policy to listen attentively and seriously to all items which Mr. Rice discusses with me and to take follow-up action where indicated. The failure in this instance was not due to lack of appreciation for his interest and information.

In addition, the post-analysis of this case has pointed up areas in our negotiating process and in Ingalls work practices which will revive further investigation by me and my staff in our continuing efforts to tighten costs and controls of the Contractor's work.

Sincerely yours,

C N Payne

C. N. PAYNE

Enclosure

DETAILED COMMENTS ON PNROR, PASCAGOULA MEMORANDUM OF 10 MAY 1972 TO VADM H. G. RICKOVER

1. The memorandum stated that approximately 230 man-hours of electrical craft time were spent in the reactor compartment.
Comment: Return costs indicate that a total of 609 direct electrical craft man-hours were charged of which 76 hours were expended in the shop engraving cable sheathing and other prefab work. Seventy-six hours were spent in training briefings, and back-up workers were held on standby because of anticipated high radiation and high temperature in the reactor compartment. The Supervisor will further investigate the records for detailed charges and usage of manpower.

2. The memorandum noted that 144 man-hours of supervision were charged to the job. (This was the initial proposal; the actual charges were 112 man-hours.)
Comment: The initial proposal was rationalized as follows: Two supervisors for two shifts to conduct training sessions and craft briefing (32 MH) - one shop supervisor for overseeing shop work (32 MH), one ship supervisor available at all times (72 MH). Mr. Rice's conclusion that supervisory personnel could have only been used on a limited basis for this job, since they could have been expected to have been used for other overhaul or new construction submarine work is a logical and reasonable conclusion. Since return costs show that they, in fact, were charged for 112 man-hours (in contrast to a 144 MH estimate), the records would indicate little diversion to other submarine work from this job. However, I intend to have this point more thoroughly checked to the extent possible.

3. The memorandum cited Ingalls claim for 196 MH for NQA personnel. (The proposal was in fact for 202 MH; the actual charges were 156 MH).
Comment: The significant tasks performed by NQA, in addition to the approximately 26 hours spent in the reactor compartment, were in processing rip-outs and inspecting the prefabrication work in the shop. Mr. Rice's comments that NQA does not inspect temporary shielding are correct. This will also be a matter of further inquiry by the Supervisor, especially into the practice of assigning and changing NQA personnel, both in view of the disparity between proposal and return cost, and of the seemingly excessive changes in the return costs.

4. The memorandum commented on seemingly excessive overtime proposed. (The proposal was for 144 MH. Reactor access logs show about one half of this.)
Comment: This resulted from back-up workers held in standby because of the anticipated high radiation and high temperature conditions in the compartment

5. The memorandum cites that the Radiological Engineering estimate of 104 MH for design and engineering effort associated with lead shielding appears excessive.
Comment: The Supervisor agrees. Return costs are not available, but further investigation of records will be conducted to attempt to determine the actual. used and the reason for the estimate. The same comments apply to the 12 MH estimate for Nuclear Quality Engineering.

Enclosure (1)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
27 June 1972

RADM C. N. Payne
Supervisor of Shipbuilding,
  Conversion and Repair
Pascagoula, Mississippi 39567

Ref: (a) VADM Rickover ltr dated 15 May 1972 to RADM Payne
  (b) RADM Payne ltr Ser 100-14 dated 31 May 1972 to VADM Rickover

Dear Admiral Payne:

By reference (a) I forwarded you a memorandum which I received from my representative at Ingalls concerning the recent settlement by your office of an Ingalls' claim for repairing pressurizer heater cables in the USS GREENLING (SSN 614). This data submitted by my representative indicated that the Ingalls' claim was grossly excessive, but that your office agreed to an increase in contract price of 97% of the amount claimed. I requested your comments on the settlement.

In reference (b) you concurred in the facts outlined in my representative's memorandum, but you disagreed with his conclusions. You indicated that the settlement was proper based on information available at the time. The enclosure to reference (b) provided detailed comments on the points made by my representative.

My review of the information provided in reference (b) still indicates that this settlement was excessive, possibly by as much as a factor of two. Enclosure (1) contains detailed comments on the information presented in reference (b). In short it appears:

(a) Ingalls assigned excessive numbers of people to this work--far more than were required for the amount of work performed.

(b) Ingalls cost charging practices appear questionable. In several instances it appears the amount of time charged to this work exceeded the time actually worked.

(c) Your office did not take adequate action to control the cost of this work, and did not utilize all the information available in pricing this change.

I am informed that the contract prices for overhauling USS GUARDFISH (SSN 612) and USS GREENLING (SSN 614) were increased by 32 and 27 percent respectively as the result of charge and claim settlements. These increases are almost twice those experienced at Electric Boat and Newport News on submarine overhaul work and far greater than should be expected under a cost type contract. It appears that your office is allowing excessive claims and changes and that improvement is required in your surveillance of Ingalls work planning. I recommend that you look into these matters immediately to determine what corrective action is required. Further, it is requested that you reexamine the basis for settlement of the claim for repair of the pressurizer heater cables and that you require a contract repricing. I recommend that you do likewise for other changes that have been settled in the manner of this change in GREENLING.

I am sending a copy of this letter to the Commander, Naval Ship Systems Command with the suggestion that the pricing of changes by Supervisors of Shipbuilding at all private yards be reviewed to determine whether similar problems exist.

H. G. Rickover
H. G. RICKOVER

Encl:
(1) NAVSHIPS 08 Comments on SUPSHIPS Pascagoula
Letter dated 31 May 1972

Copy to:
COMNAVSHIPSYSCOM

DETAILED NAVSHIPS 08 COMMENTS ON SUPSHIPS PASCAGOULA LETTER 100:CNP:nlw Ser:100-14 dated 31 May 1972

SUPSHIPS PASCAGOULA STATEMENT:

"Return costs were not available at the time of the settlement"

NAVSHIPS 08 COMMENT:

This statement is not understood. The date of settlement was seven weeks after the work was completed and five weeks after completion of overhaul. Return costs should have been available.

SUPSHIPS PASCAGOULA STATEMENT:

"The Navy negotiators were also mindful of the fact that only the actual costs (third column) would be charged finally to the Government under the Cost-plus-incentive-fee type contract."

NAVSHIPS 08 COMMENT:

This statement indicates the Supervisor of Shipbuilding, Pascagoula personnel do not understand the importance of negotiating reasonable target costs on CPIF contracts. Under a cost-plus-incentive-fee type contract where the costs are underrun, the contractor receives his return costs, target fee and a percentage of the underrun costs as additional fee. It is always to the contractor's advantage to establish a high target cost and target fee on contract changes.

SUPSHIPS PASCAGOULA STATEMENT:

"Return costs indicate that a total of 609 direct electrical craft man-hours were charged of which 76 hours were expended in the shop engraving cable sheathing and other prefab work. Seventy-six hours were spent in training briefings, and back-up workers were held on standby because of anticipated high radiation and high temperature in the reactor compartment."

NAVSHIPS 08 COMMENT:

Ingalls proposal for electrical crafts was 748 man-hours. The settlement recognized 706 man-hours and 609 man-hours were charged. Reactor compartment access records show only 230 man-hours of electrical craft time spend in the reactor compartment. Allowing 152 man-hours noted above for prefab and training, leaves 334 man-hours for standby workers. This number of standby workers assigned exclusively for this job appears unreasonable and excessive. Apparently the standby workers were not assigned to other work, subject to call if needed for the repair of the pressurizer heater cables. Reasonably accurate radiation and temperature levels should have been available in planning for the work and the assigned workers should have been adjusted based on actual conditions. The statement that this large number of standby workers was required because of anticipated high radiation and high temperatures is not reasonable because:

(a) The average radiation dose rate for all of the electric shop personnel working the GREENLING pressurizer heater job was less than 10 mr per hour and the average total radiation exposure for all electric craft personnel who worked this job (excluding the low exposure of the electrical Supervisor) was only about one-third the allowable weekly limit. No worker exceeded the allowable weekly exposure limit of 300 mr for the entire job.

(b) The average number of hours actually spent in the reactor compartment by all of the electrical craft personnel who worked this job (excluding Supervision) was 3.1 hrs per shift per man. In several instances individual electricians worked at least 6 hours in the reactor compartment during one shift.

SUPSHIPS PASCAGOULA STATEMENT:

"The memorandum noted that 144 man-hours of supervision were charged to the job. (This was the initial proposal; the actual charges were 112 man-hours.) Comment: The initial proposal was rationalized as follows: Two supervisors for two shifts to conduct training sessions and craft briefing (32 MH) - one shop supervisor for overseeing shop work (32 MH), one ship supervisor available at all times (72 MH). Mr. Rice's conclusion that supervisory personnel could have only been used for other overhaul or new construction submarine work is a logical and reasonable conclusion. Since return costs show that they, in fact, were charged for 112 man-hours (in contrast to a 144 MH estimate), the records would indicate little diversion to other submarine work from this job."

NAVSHIPS 08 COMMENT:

Mr. Rice's conclusion was that the amount of Supervisor time charged was excessive. Most of the work was performed in the reactor compartment. Actual supervision in the reactor compartment totaled about 10 man-hours. Therefore most of the remaining supervisor time charged to this job should have been charged to other shipyard work.

SUPSHIPS PASCAGOULA STATEMENT:

"The memorandum cited INGALLS claim for 196 MH for NQA personnel. (The proposal was in fact for 202 MH; the actual charges were 156MH). Comment: The significant tasks performed by NQA, in addition to the approximately 26 hours spent in the reactor compartment, were in processing rip-outs and inspecting the prefabrication work in the shop. Mr. Rice's comments that NQA does not inspect temporary shielding are correct. This will also be a matter of further inquiry by the Supervisor, especially into the practice of assigning and changing NQA personnel, both in view of the disparity between proposal and return costs and of the seemingly excessive changes in the return costs."

NAVSHIPS 08 COMMENT:

It is assumed that "changing" in line 8 and "changes" in line 9 should read "charging" and "charges" respectively. In view of these excessive charges, the DCAA auditor should make a through investigation of Ingalls cost accounting practices.

SUPSHIPS PASCAGOULA STATEMENT:

"The memorandum cites that the Radiological Engineering estimates of 104 MH for design and engineering effort associated with lead shielding appears excessive.
Comment: The Supervisor agrees. Return costs are not available, but further investigation of records will be conducted to attempt to determine the actuals used and the reason for the estimate. The same comments apply to the 12 MH estimate for Nuclear Quality Engineering."

NAVSHIPS 08 COMMENT:

The statement is not understood. Return cost should be available. Again, it appears that the Supervisor of Shipbuilding and the DCAA Auditor should throughly investigate these charges.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-553

1 8 JUL 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Progress Payments on Contract N00024-68-C-0342 with Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, for construction of SSNs 680, 682, and 683

1. Litton Industries, Ingalls Nuclear Shipbuilding Division, recently requested an adjustment in the subject contract billing price from target to ceiling. In looking into this matter I found that:

a. In September 1971 the Defense Contract Audit Agency (DCAA) auditor at the shipyard reported that Litton had over-billed the Navy $13.3 million in progress payments under this contract.

b. In December 1971 the DCAA auditor again reported an over-billing by Litton. At that time the over-billing totaled $9.1 million.

c. On 10 July 1972 NAVSHIPS 02 asked the Supervisor of Shipbuilding to review progress billings on this contract in the light of information submitted with Litton's request for an increase in the contract billing base.

d. The DCAA auditor at the shipyard today advised that Litton's current over-billings total about $9.8 million on this contract.

2. It appears that for a long time the Navy has been over-paying Litton by a substantial amount. It also appears that NAVSHIPS took no action on this matter even after the DCAA auditor twice brought it to NAVSHIPS' attention. In effect NAVSHIPS has granted a $10 million interest free loan to Litton.

3. I recommend:

a. Immediate action should be taken to recover any contract over-payments from Litton.

b. Progress payments on all other NAVSHIPS contracts with Litton should be reviewed to determine whether similar over-payments exist.

c. A formal investigation of the Navy's handling of Litton progress payments should be made to establish responsibility for the over-payment and appropriate disciplinary action should be taken.

4. As the over-payment to Litton may be symptomatic of the practice at other private yards, the Navy should also review the method of making progress payments at these yards. Further NAVSHIPS should establish adequate controls over progress payments to preclude future over-payments.

5. I would appreciate being advised of what action you take on this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Assistant Secretary of the Navy
(Financial Management)
Chief of Naval Material
Ships 02
05
00J

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
05:REH:con
Ser 150-05
11 AUG 1972

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: NAVSHIPS Contract N0024-68-C-0342 with Ingalls for Construction of SSN's 680, 682, 683; progress payments for

Ref: (a) SHIPS 08 Memorandum for COMNAVSHIPS of 18 July 1972

Encl: (1) Proposed Memorandum for the Deputy Commander for Nuclear Propulsion

1. We have investigated the matter of the subject progress payments to Ingalls which you drew to our attention by reference (a). In view of the length of the attached, I have made it an enclosure which your staff can examine in detail.

2. You were correct regarding overpayment on the subject contract although we are not in agreement with the amounts indicated by DCAA or the method by which he arrived at them. As shown in the enclosure the overpayment appears to have been limited to material. Labor progress appears to be adequately measured. The cause of the material overpayment will be corrected prior to the next progress payment.

3. Our investigation also disclosed other weaknesses at Pascagoula which we are taking immediate action to correct. In addition, we are in the process of reviewing the progress payment techniques at other Supervisor's offices involved in new construction and conversion. We shall take prompt action to correct any discrepancies which we may find.

R C Gooding

R. C. GOODING
Rear Admiral, USN
Commander, Naval Ship Systems Command

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Assistant Secretary of the Navy
(Financial Management)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
054:HV:dch
Ser 560-054

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: NAVSHIPS Contract N0024-68-C-0342 with Ingalls for Construction of SSN's 680, 682, 683; progress payments for

Ref: (a) SHIPS 08 Memorandum for COMNAVSHIPS of 18 July 1972
(b) DCAA, Pascagoula, report of 13 September 1971
(c) DCAA, Pascagoula report of 16 December 1971
(d) COMNAVSHIPS ltr 0511:TG:gs Ser 332-0511 of 8 November 1971

1. By reference (a) you called attention to two DCAA Audit Reports, references (b) and (c), that reported a continued over-billing by Ingalls on the subject contract, thus, in essence, gaining for Ingalls a $10M interest free loan. You recommended that progress payments on all NAVSHIPS contracts be reviewed for overpayment, that any overpayment of Litton be recovered, that adequate controls be established to preclude future overpayment, and that appropriate disciplinary action be taken.

2. Reference (b) is the response to a NAVSHIPS request that DCAA evaluate Ingalls' request for an increase in the billing price of the subject contract. The Resident Auditor found the incurred cost as of 24 June 1971 to be $76,589,577 and found also that the contractor's operating records supported an actual cost of $79,323.000 thru the end of the contractor's fiscal year (31 July 1971). The Auditor reported that the contractor had refused access to his General Ledger and that the incurred costs were overstated by an undetermined amount because of subcontract retentions and any applicable "other income" credits. The Auditor then used the contractor's unsupported estimate that final cost of the contract would be $153,198,000 as the basis for measuring fiscal progress, related his calculation of fiscal progress to physical progress, and concluded that the contractor had overbilled by $13,287,421 on the subject contract. There is a fallacy in this approach in that incurred cost and estimate to complete bear no direct relation to work actually accomplished or to that required by the contract. It deals with current and projected expenditures rather than progress and thus can not describe earned value which by the terms of the contract is to be based on physical progress. Therefore, NAVSHIPS considers the method used by the Auditor to compute independently the total progress in the subject contract to be invalid.

3. Reference (c) is a continuation of the Auditor's review of Ingalls' billing policies, procedures, and practices. It notes that in the interval between issue of references (b) and (c), the contractor had revised the estimated final cost of the contract from $153.198,000 to $147,590,000. However, he continued to estimate the total progress

054:HV:dch
Ser 560-054

in the contract by relating incurred costs to the contractor's unsupported estimate of final cost and concluded that the contractor had over-billed by $9,130,402 as of 31 October 1971.

4. The Auditor has since been given access to the General Ledger and has advised the Supervisor that the overstatement of incurred costs as of 24 June 1971, noted in reference (b), amounted to $551,591. The practice of including subcontract retainage in billings has been corrected. The contractor now certifies on each invoice that the amounts requested for progress payments to subcontractors do not exceed the progress payments made by the contractor. The Auditor also advised that the overstatement of incurred costs as of 24 June 1971 for failure to credit the contract for "other income" was found to be less than $20,000.

5. The procedures followed by SUPSHIP Pascagoula in making progress payments on the subject contract have been reviewed in depth to determine:

a. Validity of the DCAA report of over-billing on the subject contract.

b. Adequacy of SUPSHIP Pascagoula's procedures and practices for computing progress payments.

c. Need for additional NAVSHIPS guidance to preclude possible future over-payment.

6. Incremental payment on the subject contract is a contractual requirement covered by the Payments Clause (Clause 8) of the General Provisions. Physical progress in the contract is the basis for payments. The general procedures for determining and reporting progress are established by the Ship Acquisition Contract Administration Manual (SACAM). These procedures effect an earned value system in which the values based on a set of progress factors established by NAVSHIPS in conjunction with the Supervisor and the contractor. The detailed procedures for measuring progress within each progress factor are established by the Supervisor. In November 1968 NAVSHIPS established the progress factors for the subject contract. The first level of this breakdown established a 60.85% labor/39.15% material split of the total value of the contract for progress measurement purposes.

7. The SACAM provides a means for adjusting progress factors to reflect significant changes in construction techniques. During a Quarterly Production Progress Conference on 11 May 1971. PMS-381 requested that the progress factors be adjusted to reflect changes in the contractor's Make/Buy Plan that had occurred much earlier. The Supervisor requested the contractor to submit revised progress factors and the contractor responded with revised factors which provided a

first-level split of 54.21% labor/45.79% material. These revised factors were submitted to NAVSHIPS on 13 July 1971 and approved on 8 November 1971 by reference (d).

8. In reviewing the Supervisor's determination of total progress the validity of labor progressing was readily established. A Navy/Marad team conducted a production audit of Ingalls during the period of 2-13 August 1971. The production audit included the subject contract. As part of the production audit an independent estimate of physical progress of each SSN was made under the direction of NAVSHIPS production analysis personnel. The team included ship progressmen from SUPSHIPS Groton and Newport News with recent experience in determining physical progress on the same class of submarines at Electric Boat Division or Newport News. The manufacturing labor progress, which encompassed the bulk of unexpended effort in the contract, was found to be 57.0% for the SSN 680, vice the 56.5% reported by the contractor; 34.0% for SSN 682 vice 34.5%; and 21.0% for SSN 683, vice 20.0%. The production audit team's figures represent progress as of 10 August 1971 while the contractor's figures represent progress as of 31 July 1971. It is considered that the close agreement between the labor progress estimates of the production audit team, the Supervisor, and the contractor confirms the adequacy of the procedures being used by the Supervisor and the contractor to measure labor progress. As was noted in reference (d), however, material progress appeared to be overstated and the Supervisor was advised to audit material procurement records to "determine 'real' material progress."

9. One valid method for calculating material progress is by dividing incurred material costs by the then current estimate of the total cost of material at completion. It is obvious that the denominator is as important as the numerator and should receive the same degree of scrutiny. However, the standard practice at Ingalls has been to calculate material progress by dividing the incurred cost of material by the value of material in the target price. The Supervisor has concurred in this calculation of material progress.* The result in this contract has been an overstatement of material progress from September 1969 to date. The largest error (19%) was experienced in December 1970 and the overpayment at that time is calculated to have been approximately $7,590,000. The error has diminished as true material progress approaches 100%. As of the end of July 1972, the effect of the overstatement of material progress is a current overpayment of approximately $341,000.

10. NAVSHIPS concludes that the contractor overbilled on the subject contract for a period of about 30 months. In effect, the method used by the contractor to measure material progress violated the physical progress concept and provided instead cost reimbursement for material. A review of total payments on account of the subject contract, including overpayment and escalation, indicates that the payments were approximately equal to the incurred costs until about January 1971. Since that time,

*The method of calculation was not in violation of any existing instruction but did result in an overpayment. The SACAM will be revised to cover this.

054:HV:dch
Ser 560-054

incurred costs have exceeded total payments by a steadily increasing amount. The contractors investment in the subject contract on 25 June 1972 at 86.77% total progress in the contract was approximately $16,200,000 ($116,425,000 cost incurred as of 25 June 1972 minus $100,227,311 total payments, including escalation as of 30 June 1972).

11. In summary, we disagree with the method used by DCAA to estimate progress from which they concluded that Ingalls had been overpayed. However, our review in August 1971 while indicating adequate treatment of labor progress, detected that an incorrect method was being used for the calculation of material progress which resulted in overstatement of material progress. Hence, we do agree that an overpayment has existed. SUPSHIP Pascagoula has been directed to correct this situation on the next progress payment.

12. In the process of this review, a number of weaknesses have been identified which will be corrected as follows:

ITEM: SUPSHIP Pascagoula has not maintained the surveil lance of the contractor's total material cost estimate necessary to determine physical progress of material with reasonable accuracy.

ACTION: SUPSHIP Pascagoula has been directed to ensure that the material progress used in computing all subsequent progress payments is based on a valid and current estimate of total cost of material.

ITEM: SUPSHIP Pascagoula has placed the responsibility for determining manufacturing labor progress, previously performed in the Quality Assurance Department in the recently formed Production Surveillance Group, responsibility for determining progress of engineering labor in Code 200, and the responsibility for determining material progress in Code 400.

ACTION:

(1) SUPSHIP Pascagoula will assign the responsibility for total progress evaluation to a single production surveillance group.

(2) SHIPS 05 will issue a change to SACAM to require that responsibility for evaluating total progress in a contract be assigned to a single element in each SUPSHIP organization.

ITEM: SACAM does not provide detailed examples of material progress calculation.

ACTION: SHIPS 05 will issue a change to SACAM to provide more specific guidance regarding progress calculation methods.

054:HV:dch
Ser 560-054

12. NAVSHIPS concludes that appropriate actions have been initiated to correct the situation at Pascagoula. In addition, a meeting with representatives of all SUPSHIP offices involved in new construction and conversion will be convened in Washington within one week to instruct them regarding material progress calculation. SHIPS 054 has been assigned the responsibility for review and further action, as appropriate. Disciplinary action is considered to be unwarranted in connection with the material progress overpayment since it appears to have been a mutual error based on a procedure of long-standing. The Supervisor will be directed to investigate why corrective action was not taken following notification in November and to take such disciplinary action as may be appropriate.

13. The subject of recovery of interest on the progress overpayments has been discussed by SHIPS 05 with SHIPS 02. At the present time, an Ingalls request to adjust the billing base upwards is under consideration by NAVSHIPS. This request includes an amount for interest associated with the difference in payments at the current billing base and that which has been requested. The amount of interest due to the Government as a result of the material progress overpayments discussed in this memorandum will be considered in the establishment of the new billing base.

Copy to:
SHIPS 02
SHIPS 05
SHIPS 00J
PMS-393

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-570

2 4 OCT 1972

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Progress Payments on Contract N00024-68-C-0342 with Litton Systems, Incorporated, Ingalls Nuclear Shipbuilding Division, for Construction of SSN's 680, 682 and 683

Ref: (a) SHIPS 08 Memo for COMNAVSHIPS, Ser 08H-553, dtd 18 JUL 72; Subj: As Above
(b) COMNAVSHIPS Memo for SHIPS 08, Ser 150-05, dtd 11 AUG 72, with Encl (1) thereto; Subj: As above
(c) SUPSHIPS, Pascagoula ltr to SHIPS 02, Ser 400-273, dtd 25 SEP 72; Subj: As above

1. By reference (a) I advised you that the Navy had apparently overpaid Litton for progress on the subject contract. Specifically:

a. In September, 1971, the Defense Contract Audit Agency (DCAA) auditor at the shipyard reported that Litton had overbilled the Navy $13.3 million for progress on this contract.

b. In December, 1971, the DCAA auditor again reported an overbilling by Litton. At that time, the reported overbilling totaled $9.1 million.

c. On July 10, 1972, SHIPS 02 asked the Supervisor of Shipbuilding, Pascagoula, to review progress billings on this contract, in the light of information submitted with Litton's request for an increase in the contract billing base.

d. In July, 1972, the DCAA auditor at the shipyard advised that Litton overbillings totaled about $9.8 million on this contract.

2. Reference (b) reports the results of the NAVSHIPS review of progress payments on the subject contract at Litton. Although the NAVSHIPS review team disagreed with the DCAA auditor's calculations of the amount of overpayment, their review did confirm that Litton was, in fact, overpaid by as much as $7.5 million for material progress alone, during the period September, 1969, to September, 1972. Reference (b) states that the cause of the overpayment for material progress would be corrected promptly. I understand this has been done.

3. Reference (b) reports that labor progress appears to have been adequately measured, the implication being that Litton had not been overpaid for labor progress. However, by reference (c), the Supervisor of Shipbuilding, Pascagoula, subsequently reported that his office had recouped $1.6 million from Litton for labor progress overpayments on the subject contract.

4. Shipbuilders are required to certify that the physical (material/labor) progress, upon which progress payments are based, has been made. Had the physical progress which Litton certified actually been made, the substantial overpayments for labor and material would not have been possible. It appears, therefore, that Litton may have certified to false and misleading data, to its substantial benefit, in which case the Navy should take appropriate legal action.

5. You recently assigned a three-man team to investigate what action should be taken with respect to false and misleading data submitted by Litton in support of their multi-million dollar claim under this same contract. I recommend that you have that team review Litton's progress payment submissions to determine if the apparent false certification by Litton violate Federal statutes and, if so, what legal action can be taken.

6. I would appreciate being kept advised of what further action you take in this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
  (Installations and Logistics)
Assistant Secretary of the Navy
  (Financial Management)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-584

11 DEC 1972

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Proposed Contract Clauses Concerning Change Orders (ASPR Case No. 70-103)

Encl: (1) Proposed Changes to ASPR Section XXVI, Part 2

1. Enclosure (1) sets forth proposed contract language which I understand is currently being considered for incorporation into the Armed Services Procurement Regulations. The proposed contract clauses provide procedures for the issuance, processing and pricing of change orders.

2. The proposed new procedures present a substantial improvement over current practice and should help reduce the risk of contractors submitting large claims after the fact based on contract changes. One feature of the new procedures, however, conflicts with your efforts to see that work is priced before it is authorized.

3. The proposed sample clause, "Engineering Change Proposals (ECP's)", provides for direct reimbursement of a contractor for expenses incurred in quoting on a prospective change if the change is not ordered. Navy shipbuilding contracts have a similar provision and in my opinion it places the Government at an unnecessary disadvantage. Under this arrangement, the Government incurs an open-ended liability simply by requesting a quote to evaluate whether or not to make a change. The effect of such a request is an unpriced change—the Government has little or no control over the effort that the contractor expends, but nevertheless the Government is required to directly reimburse the contractor for his costs. For this reason, I do not favor the adoption of such a provision in the Armed Services Procurement Regulations.

4. I recommend that expenses incurred by contractors in preparing proposals be treated as a normal cost of doing business and allocated only as indirect costs. If large scale engineering studies or other extraordinary effort is required and the contractor proposes to charge the costs directly to the Government, the Government should decide at that time whether or not it wants to contract for special effort—before it incurs a liability.

5. Based on the above, I recommend that sub-paragraph 7-104.AA(c) of the proposed clause be modified to delete the provision for direct reimbursement of the contractor for preparation of change proposals. I would appreciate being advised of what action you intend to take in this regard. I would be glad to assist you in any way I can.

H. G. Rickover
H. G. Rickover

Copy to:
Commander, Naval Ship Systems Command

16 August 1972

Proposed Changes to Section XXVI

Part 2 -- Change Orders

26-200 - Scope of Part. This Part sets forth the policy and procedures governing the issuance, processing and adjusting of change orders:

(i) pursuant to the Changes clause of the contract, and

(ii) pursuant to other clauses of the contract invoking the Changes clause procedures.

26-201 General. Fair and economical processing of change orders does not occur automatically merely by issuance of an authorized change order. Procedures are necessary (i) to establish the authority of the Government to request a contractor to originate a change or to evaluate a Government-proposed engineering change; (ii) to provide for direct compensation of contractor efforts to prepare a change or to evaluate an engineering change by direction of the Government when ultimately it is decided not to issue the change; (iii) to promote the policy of forward pricing of changes when feasible; (iv) to require the contractor to submit and to certify cost or pricing data in support of his equitable adjustment; (v) to provide that changes of less than a specified magnitude may be made without price adjustment; (vi) to provide for recording of and accounting for the segregable direct costs of changed work in support of equitable adjustment claims; and (vii) to equitably adjust the contract in a single, final and complete supplemental agreement.

Enclosure (1)

26-202 Originating Engineering Change Proposals (ECP's).

(a) Engineering changes may be originated by either party to the contract. The Government needs to obtain detailed information supporting and documenting the proposed change; to evaluate the technical, cost and schedule effects of implementing the change; and to price the change in advance when possible. The clause in 7-104.AA may be used to require a contractor to submit engineering change impact evaluation information, including the maximum equitable adjustment resulting from the change.

(b) The clause in 7-104.AA includes a sample paragraph (d) supplementing the basic clause to discourage a large number of small-dollar contractor-initiated engineering changes and to reduce the administrative cost of reviewing such changes.

26-203 Change Order Accounting Procedures.

(a) Retrospective pricing of change orders can be accomplished more accurately if the Government has complete and accurate information disclosing a contractor's costs incurred in performing the changes. Recording change order costs is a difficult and complex task with respect to certain aspects of work and cost; hence contractors' accounting systems seldom segregate the costs of performing changed work as such. The 7-104.AB clause provides for change order cost segregation.

(b) It is not possible to enumerate all categories of costs attributable to a change order because such costs vary according to the particular contract and the contractor's accounting system.

Certain categories of costs are less susceptible of accounting segregation than others. Nevertheless, the following categories of direct costs normally are segregable and accountable under the terms of the 7-104.AB clause:

(i) non-recurring costs; e.g., engineering costs, and costs of obsolete work or re-performed work;

(ii) costs of added distinct work; e.g., new subcontract work, or new prototypes, or new retrofit or backfit kits caused by the change order; and

(iii) costs of recurring work; e.g., labor and material costs.

26-204 Complete and Final Equitable Adjustments.

(a) Controversies sometimes arise in interpreting what the parties to a contract intended to include within the scope and terms of the supplemental agreement equitably adjusting changes. To assure that equitable adjustments are complete, the supplemental agreement should expressly state that any elements of adjustment not claimed by the contractor, but arising out of the change order to which the equitable adjustment pertains, shall be released by the contractor.

(b) The following is a sample release for use in supplemental agreements:

RELEASE OF CLAIMS

In consideration of the modification(s) agreed to herein as complete equitable adjustments for the Contractor's ______________________ claims, the Contractor
(describe)
hereby releases the Government from any and all liability under this contract for further equitable adjustments attributable to such facts or circumstances giving rise to the aforesaid claims (except for: ____________________).

26-205 Use of Clauses

(a) The clauses in 7-104.AA and 7-104.AB are sample clauses authorized for use in any research and development or supply contract. Further, the clause in 7-104.AA may be used either by itself or by incorporation in a provision invoking MIL-STD-480 to obtain engineering change information.

(b) The clause in 7-104.AB and the paragraph (d) to supplement the clause in 7-104.AA are examples of clauses authorized for use in contracts of significant technical complexity when numerous changes are anticipated.

26-206 Change Order Administration Procedures.

26-206.1 Change Order Documentation. When change orders are not forward priced, they require two documents: the change order and a supplemental agreement reflecting the resulting equitable adjustment in contract terms.

If an equitable adjustment in the contract price or delivery terms or both can be agreed upon in advance, only a supplemental agreement need be issued, but administrative changes and changes issued pursuant to a clause giving the Government a unilateral right to make a change (e.g., an option clause) initially require only one document, the change order.

26-206.2 Authority to Issue Change Orders. (Current 26-202 text unaltered.)

26-206.3 Preparation of Change Order. All change orders shall be prepared on Standard Form 30, Amendment of Solicitation/Modification of Contract, in accordance with 16-104.4. All applicable items on the form shall be completed.

26-206.4 Issuance of Urgent Change Orders. (Current 26-204 text unaltered.)

26-206.5 Correction or Revision. (Current 26-205 text unaltered.)

26-206.6 Follow-up of Contractor Proposals. When a change order is not forward priced, equitable adjustments resulting (...remainder of current 26-206 text unaltered).

26-206.7 Analysis of Proposals. Upon receipt of the contractor's proposal, the ACO shall assure that a cost analysis, if appropriate, is conducted in accordance with 3-807.2(c) and consider the contractor's segregable direct costs of the change, where available. The ACO shall send the PCO a copy of the contractor's proposal marked to indicate whether a cost analysis will be conducted and the anticipated completion date.

26-206.8 Responsibility for Negotiation of Equitable Adjustments.

(a) Except for those change orders assigned to the ACO under 26-206.2 (...remainder of current 26-208 text unaltered).

16 August 1972

Proposed New Clauses in Section VII

7-104.AA Engineering Change Proposals (ECP's). In accordance with 26-205, the following is a sample clause:

ENGINEERING CHANGE PROPOSALS (ECP's)

(a) The Contracting Officer may at any time, in writing, request the Contractor to prepare and submit an Engineering Change Proposal (ECP) as that term is defined in MIL-STD-480, within the scope of this contract, as hereafter set forth. Upon receipt of such request, the Contractor shall submit to the Contracting Officer (i) the information specified by, and in the format required by paragraph 4 of, MIL-STD-480, and (ii) a separately enumerated statement of the ECP preparatory costs.

(b) Any Contractor ECP shall set forth a "not to exceed" price* and delivery adjustment or a "not less than" price and delivery adjustment, acceptable to the Contractor if the Government subsequently orders such change. If ordered, the equitable increase shall not exceed, nor shall the equitable decrease be less than, such "not to exceed" or "not less than" amounts. This paragraph does not preclude any revision(s) or correction(s) of an ECP in accordance with paragraphs 4.10 and 4.11 of MIL-STD-480. Concurrently with the submission of any ECP under this contract in which the proposed aggregate cost is $100,000 or greater, the Contractor shall submit to the Contracting Officer a completed DD Form 633-5. At the time of agreement upon the price of the ECP, the Contractor shall submit a signed Certificate of Current Cost or Pricing Data.

---

* Use term suitable to type of contract.

(c) If an ECP is requested but is not ordered under this contract or any other Defense contract, the Contractor's work in preparing the submission shall be treated as if ordered by the Contracting Officer under the "Changes" clause of this contract, except that the Contractor shall be entitled only to an equitable adjustment of the contract price* for such preparatory work. Such an adjustment shall be allowed only if the Contractor's accounting system provides for direct costing of bid and proposal expense. The Contractor shall not be entitled to any adjustment of the delivery schedule or time for completion of performance.

The Contracting Officer may include, in the circumstances in 26-205(b), the following paragraph:

(d) If the price* adjustment proposed for any Contractor-originated ECP (excluding any Government-requested ECP or Value Engineering Change Proposal) is __**__ (percent of the contract price*) (or $____**__) or less, such change shall be made at no adjustment of the contract price*.

---

* Use term suitable to type of contract.
** To be negotiated.

7-104.AB Change Order Accounting. In accordance with 26-205, the following is a sample clause:

CHANGE ORDER ACCOUNTING

When the Contracting Officer estimates that the cost of a change or series of related changes will exceed $100,000, he may require change order accounting. The Contractor, for each such change or series of related changes, shall maintain separate accounts, by job order or other suitable accounting procedure, of all historical segregable, direct costs (less allocable credits), of work, both changed and not changed, allocable to the change. Such accounts shall be maintained until the parties agree to an equitable adjustment for the change order.

7-204.AA Engineering Change Proposals (ECP's). In accordance with 26-205, insert the clause set forth in 7-104.AA.

7-204.AB Change Order Accounting. In accordance with 26-205, insert the clause set forth in 7-104.AB.

7-303.AA Engineering Change Proposals (ECP's). In accordance with 26-205, insert the clause set forth in 7-104.AA.

7-303.AB Change Order Accounting. In accordance with 26-205, insert the clause set forth in 7-104.AB.

7-403.AA Engineering Change Proposals (ECP's). In accordance with 26-205, insert the clause set forth in 7-104.AA.

7-403.AB Change Order Accounting. In accordance with 26-205, inse the clause set forth in 7-104.AB.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-2010

18 FEB 1973

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Progress Payments on Contract N00024-68-C-0342 with Litton Systems, Inc., Ingalls Shipbuilding Division, for Construction of SSNs 680, 682 and 683

Ref: (a) SUPSHIP Pascagoula ltr to SHIPS 02, Ser 400-273 dtd 25 Sep 72
(b) SHIPS 08 memo for COMNAVSHIPS, Ser 08H-570, dtd 24 Oct 72

Encl: (1) Memorandum for VADM Rickover dtd 3 Feb 73; Subj: Review of Labor Progress on Contract N00024-68-C-0342 (SSN 680, 682 and 683); Results of

1. Reference (a) reported that the Supervisor of Shipbuilding, Pascagoula, had recovered $1.6 million from Litton for labor progress overpayments on the subject contract. In reference (b), I noted that, because of the overpayment, it appeared Litton may have certified to false and misleading progress payment data. At that time, I recommended that you have the special NAVSHIPS Review Board investigating false and misleading data in connection with the SSN 680 claim determine if Litton's apparent false progress certifications violated Federal statutes.

2. Enclosure (1) is a report that I recently received concerning Ingalls Shipbuilding Division's progressing methods and progress calculations for early 1972. According to this report it appears that Litton has, in fact, certified to false or misleading data in support of progress payments. The report indicates that:

a. Beginning in 1971, Litton submitted to SUPSHIP Pascagoula labor progress calculations that were deliberately inflated by about 2% above the level actually calculated by the shipyard. During part of 1972, Litton overstated labor progress in its submissions by 4% above the level actually calculated. For April, May, and June 1972, Litton certified that the inflated figures reflected actual labor progress.

b. For four months of 1972, SUPSHIP Pascagoula, accepted Litton's inflated progress submissions without negotiation, and without making independent estimates of Litton's labor progress as required by NAVSHIPS procedures.

c. As a result of these actions, Litton was overpaid on labor progress for SSNs 680, 682 and 683 by about $2.5 million in April, May, and June, 1972.

d. In all likelihood, similar overpayments have been made on other Navy contracts with Litton. A brief review indicates that the Supervisor of Shipbuilding, Pascagoula, accepted Litton's labor progress calculations on the contract for ammunition ships (AE 32-35) during the April - June 1972 period. If Litton overstated progress on this contract or other contracts as it did on the submarine contract, similar overpayments could have resulted.

3. I recommend the following:

a. This memorandum and enclosure (1) should be promptly forwarded to the NAVSHIPS Review Board in connection with its investigation of false and misleading information submitted by Litton in support of the SSN 680 claim.

b. NAVSHIPS should initiate a review of progress payments made during the past few years on other Navy fixed price contracts with Litton, e.g., the AE 32-35 and DD 963 class destroyer contracts.

c. NAVSHIPS should take prompt steps to tighten progress payment procedures at SUPSHIP Pascagoula, and other shipyards to preclude further overpayments.

4. I would appreciate being kept advised of what action you take in this matter.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Assistant Secretary of the Navy
(Financial Management)
Chief of Naval Material

OPNAV 5216/144 (REV 6-70)
S/N 0107-776-6099
DEPARTMENT OF THE NAVY

Memorandum

DATE 3 February 1973

FROM R. E. Murphy R E Murphy

TO VADM H. G. Rickover

SUBJ Review of Labor Progress on Contract N00024-68-C-0342 (SSN680, 682, 683); Results of

1. As a result of the repayment of $1.6 million made in September 1972 by Ingalls to the Government due to overprogressing of labor on the subject contract, I reviewed:

a. Methods used by Ingalls to determine labor progress.

b. Labor progress claimed by Ingalls in submissions to SUPSHIPS.

c. Labor progress made on subject contract as recorded by Ingalls' internal progress system.

d. Negotiated labor progress certified to on invoices for progress payments to Ingalls.

Specifically, my review was made to determine if a demonstrable difference existed between Ingalls' internal labor progress calculations and those certified by Ingalls for progress payment purposes. No attempt was made to determine the accuracy of material progress claimed by Ingalls on the subject contract.

2. NAVSHIPS and Ingalls have negotiated the labor value of the total contract value to be 54.21% (i.e., the total dollar value of labor on the contract is estimated to be 54.21% of the final dollar value of the contract). Given an original target price of $107,416,500 for the contract, it is obvious that a discrepancy in statement of labor progress as small as one percent can result in a substantial mispayment ($582,304).

3. In order to calculate labor progress made on a vessel, Ingalls divides the labor required into several hundred production accounts (e.g., Steam Generators, Air Conditioning Systems, MG Sets, etc.). A budget in man-hours (called planned cost) is made up for each account and revised semi-annually or as contract changes occur. Each account is then broken down into one or many discrete work packages in three different forms:

a. Manufacturing Bill of Material (MBM) - Primarily shop work.

b. Installation Group List (IGL) - Installation, fabrication and erection of the vessel.

c. Construction Service Order (CSO) - Primarily function of time or production service tasks.

Approximately 2500 of the above are issued for construction of an SSN. Each has its own planned cost measured in man-hours. Labor progress is measured at this level. IGL's and MBM's not started are measured at 0%. IGL's and MBM's completed are measured at 100% less an historical factor for rework. Construction Service Orders are measured by various "bogey curves" which are derived from historical data (e.g., when vessel is 30% complete carpenters are 45% complete). Thus the major difficulty in determining a vessel's progress (assuming estimates and distribution of budget man-hours between the 2500 line items is correct) is measuring the progress of the MBM's and IGL's in process. This is done by (a) determining a performance factor for each cost center based on the vessel's completed groups (actual ÷ budget, (b) multiplying this factor times actual man-hours expended against the in process group (result called earned hours), and (c) dividing earned hours by budget hours. The above calculations are combined into production accounts for progress payment purposes.

4. Ingalls calculates labor progress for vessels under construction at the end of each month. SUPSHIPS, however, requires Ingalls to submit its calculations of vessel labor progress in the middle of each month. Submission of labor progress to SUPSHIPS is in terms of the BUSHIPS Consolidated Index (BSCI) which consists of standard Navy production accounts. Each BSCI account possesses a negotiated weight or a percent value of the total contract value. As each BSCI account has one or more corresponding Ingalls production accounts, the Ingalls production accounts are grouped into BSCI accounts by use of a standard form. Earned hours and budget hours are then summed for each BSCI account and the appropriate percentage completion calculated (Earned ÷ Budget). The figures obtained at month end are compared with the previous submission of labor progress for consistency. Two weeks later, the figures are projected to the end of the month using the latest man-hour expenditures recorded against the accounts as a guide for projection (e.g., labor progress as projected for 30 October is due in SUPSHIPS on 15 October. Submission is based on actual calculations of labor progress made on 30 September, comparison with 15 September labor progress projection for 30 September, and projected to 30 October using man-hour expenditures recorded during the first two weeks of October as a guide). The labor progress projections submitted to SUPSHIPS are then negotiated. SUPSHIPS makes an independent estimate of progress. The negotiated labor progress is then used on invoices for progress payment purposes.

5. I first reviewed SUPSHIPS records to check (a) Ingalls' submissions of labor progress to SUPSHIPS, (b) SUPSHIPS independent determination of labor progress, and (c) the negotiated values of labor progress. The results of this review are shown in Attachment I. The significant items resulting are:

a. During the period April through July, 1972, no independent estimates of labor progress were made by SUPSHIPS.

b. During the above period, SUPSHIPS accepted Ingalls' progress submissions without negotiation.

c. The August, 1972, labor progress submission to SUPSHIPS resulted in a negative change in labor progress on the three SSN's.

6. After the above review, I then obtained copies of the Ingalls' Navy Progress Work Sheets for Submarines for the month ends of April, May and June, 1972. The work sheets showed Ingalls' calculations of percent labor completion for each BSCI account. I then multiplied the percentages of completion for each BSCI account (SSN682) or BSCI account group (SSN680 and 683) by the negotiated weight factors to determine the total labor value of physical completion which should have been submitted to the Navy for those months.

7. I next obtained copies of invoices for progress payments submitted to and approved for payment by SUPSHIPS. I then compared Ingalls' internal labor progress converted to Navy BSCI accounts with the certified statements of physical progress made by Ingalls on the invoices. The difference in percentage labor progress was then monetized using the format and constants included on the invoices. The results of the comparison are shown below with corresponding values of overpayment of progress:

Overstatement and Overpayment of Progress
N00024-68-C-0342
Difference Between Invoice and Ingalls' Internal Progress Report
(both based on BSCI weight conversions)
(percents of total contract)

End of:	April 1972		May 1972		June 1972	
SSN680	3.58%	$1,307,409.74	2.90%	$1,061,297.95	2.53%	$ 897,598.05
SSN682	1.75%	$ 637,213.60	1.92%	$ 700,271.90	2.53%	$ 923,308.32
SSN683	1.53%	$ 556,780.52	1.91%	$ 696,506.75	1.92%	$ 700,614.63
Overpayment Total:	2.3 %	$2,501,403.86	2.2 %	$2,458,076.60	2.3 %	$2,521,521.00

8. During the course of my review I contacted several of the Ingalls personnel who are involved with determination of labor progress and progress payments. I first met with R. A. Goldbach (Director, Division Planning) under whose cognizance labor progress determination falls. He informed me of Ingalls' general policies regarding progressing and gave an overview of how Ingalls' progressing system works. While

discussing accuracy of the system he mentioned that labor progress submissions were off last spring but then stopped himself saying he had already said too much. His instructions to his staff (H. Bullock, Manager of Industrial Engineering and W. Foster, Manager of Cost Engineering) were that I was to see how Ingalls progressed vessels today. If I wanted to see yesterday's data, I was to return to Goldbach who would have A. Dunn (Director, Contracts Administration) present. On 29 December 1972 I did return. Goldbach stated that up until a year and a half ago, SUPSHIPS generally accepted Ingalls' labor progress submissions without negotiation. Due to what Goldbach considered arbitrary positions taken by SUPSHIPS in negotiating labor progress at that time, Goldbach had labor progress submissions to SUPSHIPS increased by 2% above that calculated. This was to leave a margin to be negotiated out by SUPSHIPS prior to submission of invoices. Any settlement below the Ingalls' calculated internal progress then required Goldbach's approval. Goldbach then mentioned an OPNAV memorandum of last spring which urged the Navy to have all of its money obligated by 30 June 1972. Goldbach stated the memorandum was interpreted locally as meaning progress payments should be increased by 2%. Ingalls did this by adding another 2% to the 2% overprogress already contained in Ingalls' labor progress submissions. I then asked Goldbach and Dunn why Dunn had to be present for this discussion. Dunn stated that (a) he had written all of Ingalls' letters on progress payments last year and (b) that he wanted it made clear that Ingalls has never officially admitted to being overprogressed. Goldbach then gave me access to all the Ingalls' past labor progress records.

9. While the above discussion indicated Ingalls' purposeful overstatement of labor progress on SSN680, 682 and 683, Dunn's disclaimer of Ingalls never officially admitting overprogress means that the calculations I have made in this review will have to stand alone. My calculations of actual progress tend to confirm that the difference between the projected and the actual progress figures did not result from inaccurate projection, but resulted instead from a deliberate overstatement of labor progress. This can be demonstrated by tracking labor progress on the SSN682. At the end of April, May and June, 1972, Ingalls' internal labor progress calculations (converted to BSCI) showed percent value of labor completed to be 66.30%, 70.59% and 73.30%, respectively. The April actual was then supposed to be projected for the May submission which was 73.95%. Actual Ingalls' labor progress at the end of May was 70.59%. Although the actual Ingalls' labor progress at the end of May was 3% less than that submitted to SUPSHIPS two weeks earlier, Ingalls continued to show an increase of labor progress in its submission for 30 June, 77.95%. The actual at the end of June was 73.30%. At the end of each month, Ingalls' own figures clearly showed overprogress, yet Ingalls continued the overprogress in each of its monthly submissions of progress to SUPSHIPS. Apparently the overstatement of labor progress was deliberate.

10. In summary, my review shows that:

a. During the period April through July, 1972, SUPSHIPS accepted Ingalls' submissions of labor progress without question.

b. During the same period, Ingalls' labor progress on SSN680, 682 and 683 was overstated to the extent that Ingalls was overpaid approximately $2.5 million.

c. The overstatement of labor progress appears to be the result of deliberate Ingalls' policy, not errors in projections.

Attachment I

PERCENT LABOR PROGRESS
N00024-68-C-0342

Date	SSN680			SSN682			SSN683		
	Ingalls	Negotiated	Navy	Ingalls	Negotiated	Navy	Ingalls	Negotiated	Navy
Dec. 71	78.05	76.42	76.57	54.12	53.08	53.25	36.29	35.87	36.00
Jan. 72	81.18	79.35	79.35	57.89	56.10	56.10	39.45	38.44	38.44
Feb. 72	84.43	83.03	83.03	61.67	59.81	59.81	41.95	40.82	40.82
Mar. 72	88.36	86.26	86.50	65.54	63.35	63.61	43.98	43.02	43.19
Apr. 72	90.50	90.50	90.50	69.53	69.53	69.53	47.28	47.28	47.28
May 72	93.21	93.33	93.21	73.95	74.14	73.95	50.39	50.52	50.39
Jun 72	95.19	95.24	95.24*	77.95	77.95	77.95	53.99	53.99	53.99
Jul 72	96.44	96.44	96.44	80.95	80.95	80.95	56.64	56.64	56.64
Aug. 72	96.66	96.66	95.71	78.74	78.74	78.74	56.61	56.61	56.61
Sep. 72	97.27	97.14	97.14	80.16	80.63	80.53	59.12	59.13	58.79

Figures represent initial Ingalls and SUPSHIPS estimates.

The 0 difference between Navy and Ingalls estimates for April through July also apply to AE ships during the same time period.

* Navy estimate originally 95.19, crossed out and increased to 95.24. Later figure used for payment equation.

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
0541:ES:dch
Ser 46-0541
14 MAR 1973

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: Progress Payments to Ingalls Shipbuilding Division

1. I have reviewed your memorandum (08H-2010) of 13 February 1973 and concur that overpayments similar to those on Ingall's SSN construction contract may have been made on other Navy contracts with Litton. Accordingly, I have taken the following actions regarding your recommendations in this matter:

a. Forwarded your memorandum immediately to the NAVSHIPS Review Board.

b. Initiated a review of progress payments made on other Navy fixed-price type contracts with Litton. The review will begin this month. It will be conducted by representatives from SHIPS 054, PMS 383 and PMS 389 and will look at the AE 32-35 and DD 963 programs.

c. Forwarded your memorandum to Rear Admiral Payne and instructed him to be sure that all future payments to Litton on all Navy fixed price type contracts are based on actual physical progress made and not on physical progress claimed.

d. Each SUPSHIP will be advised of the types of problems experienced recently in progressing and progress payments and will be instructed to review the progressing procedures of the SUPSHIPS and assigned contractors, correct deficiencies and to report the results of this review to NAVSHIPS.

2. I will keep you apprised of any further developments or actions taken in this area.

KE Wilson

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-2016
13 March 1973

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Excessive Prices for Changes to NAVSHIPS Contracts at Litton Industries' Ingalls Nuclear Shipbuilding Division, Pascagoula Mississippi

Ref: (a) My memorandum Ser 08H-546 of 18 July 1972
(b) Your memorandum Ser 605-054 of 3 October 1972

1. In reference (a), I pointed out deficiencies in the pricing of change orders at Ingalls. I recommended that NAVSHIPS investigate the pricing of contract changes at Ingalls as well as other private yards to determine if similar problems exist.

2. In reference (b), you advised me that you had directed SHIPS 054 to look into the pricing of change orders at Ingalls and other private shipyards. You indicated a report would be issued by 1 December 1972.

3. To date, I have not received any report regarding the pricing of change orders at Ingalls or any other shipyard. I would appreciate being advised of the action being taken in this matter.

H. G. Rickover

Copy to:
NAVSHIPS 02
NAVSHIPS 04
NAVSHIPS 05

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON. D. C. 20360

IN REPLY REFER TO
08H-2039
2 6 MAY 1973

MEMORANDUM FOR THE COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Progress Payments on Contract N00024-68-C-0342 with Litton Systems, Inc., Ingalls Shipbuilding Division for Construction of SSN's 680, 682 and 683

Ref:
(a) My memo for COMNAVSHIPS, Ser 08H-553 dtd 18 Jul 1972
(b) COMNAVSHIPS memo for VADM Rickover Ser 150-05 dtd 11 Aug 1972
(c) SUPSHIPS, Pascagoula ltr to COMNAVSHIPS (02) Ser 400-273 dtd 25 Sep 1972
(d) My memo for COMNAVSHIPS, Ser 08H-570 dtd 24 Oct 1972
(e) My memo for COMNAVSHIPS, Ser 08H-2010 dtd 13 Feb 1973, with encl (1) thereto

Encl: (1) Memorandum for VADM Rickover dtd 23 May 1973, subj: Review of material progress overpayments on SSN 680, 682, and 683 contract; results of

1. By reference (a) I advised you of a number of indications that the Navy had been overpaying Litton by a substantial amount for progress payments under the subject contract. Reference (b) reported that a NAVSHIPS review confirmed that Litton was overpaid for material progress, but that labor progress appeared to have been adequately measured. Subsequently, by reference (c), the Supervisor of Shipbuilding, Pascagoula, reported that his office had recouped $1.6 million from Litton for labor progress overpayments on the subject contract, in addition to $0.3 million for material progress overpayments. In reference (d), I recommended that you have the NAVSHIPS Review Board investigate Litton's progress payment submissions. This was to be in conjunction with their investigation of false and misleading data submitted by Litton in support of the SSN 680 claim.

2. I also asked my representative in Pascagoula to look into this matter. He reported that Litton had overstated labor progress in the spring of 1972, which resulted in a $2.5 million overpayment, and that Litton certified the accuracy of progress payment invoices during that period--even though they apparently knew these invoices were based on false or misleading data. By reference (e) I forwarded his report to you.

3. Enclosure (1) is a report I recently received concerning material progress reported and claimed by Litton on the subject contract. Enclosure (1) reports that Litton's material progress estimates were inflated and, as a result, substantial overpayments were made to Litton. The report contains evidence that Litton repeatedly and knowingly certified to false or misleading material progress data in connection with progress payment invoices. The report shows that:

a. Litton was overpaid by as much as $7.59 million due to overstatement of material progress, according to NAVSHIPS calculations;

b. At the same time Litton was using artifically low estimates of material costs for progress payment purposes, Litton was using substantially higher estimates in their claim against the Government under the subject contract;

c. By March 1971, Litton had already incurred costs for material for SSN's 680, 682, and 683 which exceeded the estimate of material costs at contract completion Litton was using for progress payment purposes. Rather than adjust their estimate of material costs at completion--as they should have done--Litton made a negative adjustment to the material costs incurred figure;

d. The shipyard's top management knew, as far back as early 1969, that their estimates of material costs at completion were too low. Yet, for a period of over three years, they continued to submit and certify to inflated progress figures upon which progress payments were based.

4. Excessive progress payments seem to be a widespread and long-standing problem with Litton. In addition to the overpayments on the subject contract, I understand that the Defense Contract Audit Agency has recently reported a $26 million progress overpayment to Litton on the DD-963 contract. Therefore, I recommend the following:

a. This memorandum and enclosure (1) should be promptly forwarded to the NAVSHIPS Review Board in connection with its investigation of false and misleading information submitted by Litton in support of the SSN 680 claim. The Board should determine whether legal action is appropriate in view of Litton's false certification on progress payment invoices, and whether criminal action should be brought against Litton officials for the false certifications;

b. NAVSHIPS should review all contracts with Litton to determine whether other overpayments have resulted from false or misleading data submitted by Litton.

5. A copy of this memorandum is being forwarded to the NAVSHIPS Inspector General to comply with the requirements of NAVSHIPS Instruction 5371.1D of 10 May 1971 entitled "Fraud, Larceny and Embezzlement in connection with Procurement, Material Management, Property Disposal and Related Matters; handling and reporting on."

H. G. Rickover

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)
Assistant Secretary of the Navy
(Financial Management)
Chief of Naval Material
Naval Ship Systems Command Inspector General

OPTIONAL FORM NO. 10
MAY 1962 EDITION
GSA FPMR (41 CFR) 101-11.6
UNITED STATES GOVERNMENT

Memorandum

TO : VADM H.G. Rickover DATE: 2 8 MAY 1973

FROM : R.E. Murphy R E Murphy

SUBJECT: Review of material progress overpayments on SSN 680, 682, 683 contract; results of

Ref:
(a) SUPSHIP, Pascagoula ltr to COMNAVSHIPS (02), 401:JJM:sew Ser 400-273 dtd 25 Sep 1972
(b) My memo for VADM Rickover dtd 3 Feb 1973
(c) VADM Rickover memo for COMNAVSHIPS, Ser 08H-2010 dtd 13 Feb 1973
(d) COMNAVSHIPS ltr to SUPSHIP, Pascagoula, 0511:TG:gs Ser 332-0511 dtd 8 Nov 1971
(e) COMNAVSHIPS memo for VADM Rickover, 05:REH:con Ser 150-05 dtd 11 Aug 1972, and encl (1) thereto

Encl:
(1) Memo from Ingalls' Director of Contracts to Ingalls' Controller (with copy indicated for the President of Ingalls) dtd 10 Oct 1972
(2) Ingalls' Progress Billing Analysis for SSN 680, 682, and 683 dtd 14 Oct 1972

1. In reference (a), SUPSHIP, Pascagoula, reported to SHIPS 02 that he had recovered from Ingalls Shipbuilding Division of Litton Industries $1.6 million for labor progress overpayments and $0.3 million for material progress overpayments on the subject contract--that is, the contractor was paid more in progress payments than he was entitled to at the time of the payments. The effect of such overpayments is that the contractor enjoys an interest free loan of Government money. Recently, I have been trying to find out what caused the overpayments.

2. In reference (b), I reported to you the results of my review of labor progress on the subject contract. That review indicated that Ingalls had overstated labor progress on SSN's 680, 682 and 683, that the overstatement extended over a period of about eighteen months, and that the overstatement appeared to be deliberate--not the result of errors in projections. By reference (c), you forwarded my report to the Commander, Naval Ship Systems Command for consideration by the NAVSHIPS Review Board in their investigation of possible false claims or fraud on the part of Litton in its business dealings with the Navy on the subject contract.

3. I have recently completed a review of the material progress overpayments on SSN's 680, 682 and 683. My current review indicates that, from January 1969, through September 1972:

a. Ingalls repeatedly calculated inflated estimates of material progress for purposes of arriving at physical progress on these three vessels;

5010-108

Buy U.S. Savings Bonds Regularly on the Payroll Savings Plan

b. Ingalls certified that this physical progress had been made;

c. Ingalls obviously knew that their estimates of material progress, which are included in physical progress, were inflated;

d. These inflated estimates resulted in multi-million dollar progress overpayments by the Government to Ingalls.

4. Under the terms of this submarine contract, the Government pays Ingalls progress payments based on the percentage of physical completion of each vessel under construction. Two separate estimates of physical completion are made for each ship. One is the estimate for labor progress, on which I reported to you in reference (b). The other is the estimate for material progress--the ratio of material costs incurred to the estimate of material costs at completion of the contract. This ratio is expressed as a percentage.

5. Ingalls overstated material progress, and thus was able to overbill the Government for progress payments, in the following manner:

a. At the time of contract award, Ingalls used as their estimate of material costs at completion of the contract the sum of $35.4 million. At that time, Ingalls planned to fabricate certain hull cylinders in-house, so that the fabrication costs were considered as labor costs, not as material costs.

b. Shortly after the contract was awarded, Ingalls decided to subcontract fabrication of these hull cylinders to Canadian Vickers and Chicago Bridge and Iron. These subcontracts totaled nearly $7 million. Although, under the contract, Ingalls is entitled to subcontract fabrication work, Ingalls' decision to do so should have caused a corresponding increase in their estimate of material costs to be incurred under the contract.

c. Although the subcontracts were awarded in early 1969, Ingalls did not consider them in their estimate of material costs at completion of the contract until November 1971--almost three years later--after NAVSHIPS questioned Ingalls' figures. However, during this three year period Ingalls included these subcontract costs in their material costs incurred amounts.

d. To calculate the percentage of material progress, material costs incurred are divided by the estimate of material costs at completion. Therefore, the effect of including these subcontract costs in costs incurred, but not adjusting the estimate at completion to reflect the extra subcontracted work and other projected overruns, was to overstate the percentage of material progress. As a result, Ingalls was substantially overpaid. This was first pointed out by NAVSHIPS in November 1971, in reference (d). A review by NAVSHIPS in August 1972 (reference (e)) indicated that Ingalls was overpaid in varying amounts--by as much as $7,590,000 in December 1970 for material progress alone.

6. Based on my current review, it appears obvious that Ingalls' top management must have been aware that they were overbilling the Government for material progress on the subject contract. Yet, on their progress payment invoices, they continued to certify to physical progress figures based on material progress estimates which were obviously inflated. That Ingalls' management was aware of this situation is indicated by the following:

a. In a 10 October 1972 memo from Ingalls' Director of Contracts to Ingalls' Controller (with a copy indicated for the President of Ingalls), the Director of Contracts states:

> "As you know, we did not adjust the relationship between labor and material for the purposes of progress billing in this Contract until approximately November 1971 even though we knew from the Spring of 1969 that the relationship had changed considerably due to the approximately $7,000,000 farm out program at CV [Canadian Vickers] and CBI [Chicago Bridge and Iron]. You are requested to recompute the effect on progress payments for both labor and material that would have occurred had we adjusted the relationship between labor and material when we became fully aware of the CV and CBI orders in early 1969."

A copy of the 10 October memo from the Ingalls Director of Contracts is attached as enclosure (1); a copy of the analysis requested in his memo is attached as enclosure (2). The analysis shows that, by their own calculations, Ingalls' failure to adjust their estimate of material costs at completion of the contract resulted in an overpayment of as much as $5.9 million. As stated above, NAVSHIPS has calculated the overpayment to be as much as $7,590,000.

b. During March 1971--well before completion of the contract and eight months before Ingalls adjusted their estimate of material costs at completion--Ingalls records show that they had already incurred material costs which exceeded the $35.5 million estimate of total material costs at completion of the contract which they were then using for calculating material progress. To avoid the embarrassing situation of reporting they were more than 100 percent complete (obviously an impossibility) while there were still substantial material costs to be incurred, Ingalls had to adjust some figures. Rather than increase their estimated material costs at completion to reflect a more accurate projection, Ingalls made a negative adjustment to material costs incurred and reported that they were 99.85 percent complete.

c. In November 1971, Ingalls finally adjusted their estimate of material costs at completion when NAVSHIPS raised the issue. However, the total estimated material costs at completion figure was adjusted only by the amount necessary to reflect material progress of 99.85 percent--the percent of material progress which Ingalls had been using for progress payment calculations for the preceding eight months.

d. At the very time Ingalls was using a low figure as their estimate of material costs at completion for progress payments, they were representing to the Navy a substantially higher estimate of material costs at completion in the claim they were asserting against the Government on this same contract. Without attempting to establish the accuracy of Ingalls' figures, the discrepancies between Ingalls' representations for progress payment purposes and those made for claim purposes can be seen in the following table:

Discrepancies in Ingalls' Estimates of Material Costs at Contract Completion on SSN's 680, 682, and 683

($ in thousands)

Date of Estimate	Estimate Used by Ingalls for Progress Payment Billings	Estimate Used by Ingalls In its Claim (original and supplements 1-3)
Nov-Dec 70	$35,525	$41,215
Feb-Mar 71	35,531	42,710
Dec 71	41,560	42,507
May-Jun 72	41,726	45,838

7. In summary, my review shows that Ingalls knew, or should have known, that their estimate of material costs at completion was greatly understated. Nevertheless, they failed to make the proper adjustment to their progress payment calculations to avoid overbilling the Government. During this time Ingalls continued to certify, on their progress payment invoices, that they had achieved physical progress which was substantially greater than they must have known to be the case. As a result, Ingalls was overpaid by as much as $7.59 million according to NAVSHIPS calculations, or at least by as much as $5.9 million by their own internal calculations--in effect, an interest free loan from the Government. These overpayments would not have occurred had Ingalls certified only to that amount of progress which they had actually achieved.

8. NAVSHIPS Instruction 5371.1D of 10 May 1971 entitled "Fraud, Larceny and Embezzlement in Connection with Procurement, Material Management, Property Disposal and Related Matters; handling and reporting on" requires that: "When any instance of fraud or matter concerning the standards of conduct is observed or suspected all knowledge of the case shall be reported immediately." The instruction defines fraud as "Any willing means of taking or attempting to take unfair advantage of the Government including... making of false statements, submission of false claims..." Accordingly, I recommend that this matter be brought to the attention of the NAVSHIPS Inspector General as prescribed in the NAVSHIPS Instruction.

[illegible] Progress Payment on
SSN 680, Contract
N00024-58-C-0312

FROM W. J. Dunn PHONE 4628

cc: K. Versecke
N. J. Marandino
R. E. Davis
G. W. Howell
R. A. Goldbach
P. G. Rubury

Enclosure: (1) RADM K. L. Woodfin's letter, Ser: 1356-022 dated October 6, 1972

(2) My letter, Ser: 72-02490-125 dated July 26, 1972

(3) RADM K. L. Woodfin's letter, Ser: 98-02X dated July 10, 1972

As you are aware, over the course of the last several months it has been NavShips stated position either that Ingalls is overpaid up to $10,000,000 on subject contract or that Ingalls has been in a position of overpayment in the past on subject contract. Enclosure (1) is NavShips most recent letter on this subject. Enclosure (2) was Ingalls response to the last letter of NavShips on this subject, specifically, Enclosure (3).

I had discussions yesterday with N. J. Marandino, and it is his objective to attempt to put the subject of "overpayment" to bed once and for all. Accordingly, in order to accomplish this objective, the following data, as a minimum, will have to be prepared, and you are requested to do so.

(a) As you know, we did not adjust the relationship between labor and material for the purposes of progress billing in this Contract until approximately November 1971 even though we knew from the Spring of 1969 that the relationship had changed considerably due to the approximately $7,000,000 farm out program at CV and CBI. You are requested to recompute the effect on progress payments for both labor and material that would have occurred had we adjusted the relationship between labor and material when we became fully aware of the CV and CBI orders in early 1969. Concurrently with the results of this analysis provide the actual progress payments that were received in the same time frame up to the point where we actually made the adjustment in November 1971, thereby providing an incremental quarterly total of the over or under payment that would have existed had we adjusted the billing base when we should have.

RECEIVED
OCT 11 1972

(b) [illegible] "overpayment" identified by the Government and the $1,900,988 payback by Ingalls, are not one and the same item; that is, the $1.9 resolved the $1.6 problem. Please provide an analysis of this situation. Also contained in the $1,900,988 is a major adjustment for the 2% accelerated progress billings program specifically requested by NavShips last February. Please identify how much of the $1,900,988 is attributable to that 2%.

(c) Recompute progress payments identically to the method described in (a) above assuming a material cost at completion of $45,838,000 which is the material cost at completion provided with the SSN 680 RFA.

(d) Provide a current status based on our most recent progress billing of where we stand on the 680 contract in terms of actual cost incurred, escalation payments received, progress payments billed, retention, progress payments received, and current cash shortage position.

There is no intent in these analyses to determine whether we were "right or wrong" in our approach to progress billings. We were right, by definition, since in no case were we ever paid based on any physical progress measure other than that which was approved by SupShips in accordance with SACAM. The intent is solely to determine what the financial situation really was. This is necessary prior to taking our next steps which may well be legal action against the Government.

A. J. Dunn

AJD/cmk

1170 97.62 56.66 (18)
1.75 83.65 25.39 (1.91)
1.76 58.03 56.61 (7.113)
240.30 232.01
16.07 77.34
(2.73)
54.31
1.48
109,813
1,625

S NUCLEAR SHIPBUILDING

PROGRESS BILLING ANALYSIS

H-1174/1176 (SSN 680, 682, 683)

10-14-72
W.E. Corley

ACULATION SHEET

Encl. (A)

Rev.	3/69	6/69	9/69	12/69	3/70	6/70	9/70	12/70	3/71	6/71	9/71	12/71
Complete	1.25	3.10	[illegible]	9.91	13.92	17.64	23.75	29.43	33.58	38.2[illegible]	41.13	[illegible]
(Cx[illegible])	.72	1.18	3.20	6.37	7.55	9.56	12.87	16.06	18.20	20.74	[illegible]	[illegible]
Cost Billed	1,217	3,674	6638	9863	15957	22458	27483	31876	37171	39749	41657	[illegible]
ase	[illegible]	[illegible]	[illegible]	41447	41437	41439	41473	41629	41535	41546	41870	[illegible]
Complete	2.94	8.87	16.02	23.80	38.51	54.20	66.27	76.76	89.43	95.67	99.49	[illegible]
([illegible])	1.35	4.06	7.34	[illegible]	17.63	24.82	30.35	35.15	40.98	43.81	45.5[illegible]	[illegible]
[illegible]	2.09	5.74	10.54	16.27	25.18	34.38	43.22	51.21	59.18	64.65	72.5[illegible]	[illegible]
e	[illegible]	[illegible]	[illegible]	107606	107602	107603	107676	107861	107951	108048	[illegible]	[illegible]
ing	2234	6175	11343	17507	27094	36994	46538	55236	63885	69745	[illegible]	[illegible]
ed	228	618	1,134	1,751	2709	3699	4654	5393	5398	5402	5411	5413
(Cash)	2211	5,557	10,207	15,756	24385	33295	41884	49843	58487	64343	[illegible]	[illegible]
Cash Rec'd	2208	5719	10,514	16,354	25253	34186	43448	53414	58752	61981	[illegible]	74752
Under>	3	<162>	<307>	<598>	<868>	<891>	<1564>	<3571>	<265>	2362	[illegible]	-0-
Cost Billed	1,217	3674	6638	9863	15957	22458	27483	31876	37171	39749	[illegible]	[illegible]
ase	[illegible]	[illegible]	[illegible]	[illegible]	45838	45838	45838	45838	45838	45838	[illegible]	[illegible]
Complete	2.66	8.02	14.48	21.52	34.81	48.99	59.96	69.54	81.09	86.72	[illegible]	[illegible]
([illegible])	1.22	2.17	6.63	9.85	15.94	22.43	27.46	31.84	37.13	39.71	[illegible]	[illegible]
lete	1.05	5.35	9.83	15.22	23.49	31.99	40.33	47.90	55.33	60.45	[illegible]	[illegible]
Price	[illegible]	[illegible]	[illegible]	[illegible]	107602	107603	107676	107861	107951	[illegible]	[illegible]	[illegible]
Billing	2095	5755	10578	16,378	25276	34422	43436	51665	59729	65215	[illegible]	[illegible]
ed	210	576	1058	1638	2528	3442	[illegible]	5167	5398	5402	5411	[illegible]
(Cash)	1885	5179	[illegible]	14740	22748	30980	[illegible]	[illegible]	54331	59813	[illegible]	[illegible]
Cash Rec'd	[illegible]	[illegible]	[illegible]	[illegible]	25253	34186	43448	53414	58752	61981	[illegible]	[illegible]
/<Under>	[illegible]	[illegible]	[illegible]	<1614>	<2505>	<3206>	[illegible]	<5916>	<4421>	<2168>	[illegible]	[illegible]

# Invoiced through 12-2-71

ENCLOSURE (3)

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D C 20360

IN REPLY REFER TO
08H-2047

9 JUL 1973

MEMORANDUM FOR COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Formal meetings on financial, contractual and management matters at Ingalls Shipbuilding Division; comments on

Ref: (a) President of Ingalls letter dtd 13 June 73 to Commander, Naval Ship Systems Command

1. As you know, the President of Ingalls Shipbuilding Division of Litton Systems, Inc., has been refusing to cooperate with the Supervisor of Shipbuilding, Pascagoula, in holding formal meetings to discuss financial, contractual, and management matters at the shipyard. On May 21, 1973, you personally attempted to obtain the President of Ingalls' agreement to such meetings. Reference (a) is his response, upon which you asked me to comment.

2. In reference (a), the President of Ingalls states that he is willing "to meet with the Navy on such subjects as the Navy feels warrants my personal attention." However, he goes on to stipulate the following conditions on his meetings with the Supervisor:

> "1. The parties agree that the agenda item is such that it warrants senior management attention.
>
> "2. The parties mutually prepare the agenda, leaving the solutions to the problems to be determined at the meetings.
>
> "3. The parties have their most qualified personnel in attendance at the meetings.
>
> "4. The decisions of the meetings would be documented, where necessary, by normal correspondence between the parties."

3. My comments are as follows:

a. Conditions 1. and 2. above preclude the Supervisor from meeting with the President of Ingalls unless the President is satisfied that the meeting issue warrants his personal attention and unless his staff has first agreed with the Navy's statement of the problem. In effect, the President of Ingalls insists on veto power over those issues which the Navy may want to raise with him.

b. Condition 3. gives the President of Ingalls an excuse for not attending agreed-upon meetings--he can designate a subordinate as "most qualified" to meet with the Supervisor.

c. Condition 4. relates to repeated refusals by the President of Ingalls to sign formal minutes of meetings, which include a disclaimer statement. The disclaimer simply serves notice that whenever Ingalls considers a contract change is required as a result of the commitments, decisions or agreements made at the meeting, Ingalls will notify the Government and not proceed with the changed work until so authorized by a formal contract change. Litton has a record of submitting claims; the Supervisor of Shipbuilding is a Government representative authorized to issue contract changes. Therefore, the signed disclaimer is necessary to ensure that any statements made at the meetings are not construed by Ingalls as authorizing a change to existing contracts. It is simply good business practice—not the sign of an "adversary relationship," as the President of Ingalls maintained in reference (a)--for both parties to sign minutes which clearly set forth the substance of their meetings.

4. In my view, his conditions are unacceptable. The Supervisor of Shipbuilding is responsible for protecting the Government's interest on all Navy work at Ingalls. The Supervisor cannot properly discharge his duties if he must first obtain the permission of Ingall's President to any meeting between the President and himself in which he proposes to raise financial, contractual or management issues with the company. As the agent of the Government who is the customer, the Supervisor must be able to meet with the President of Ingalls, without the threat of claims, whenever the Supervisor concludes the issues warrant such a meeting.

5. The position taken by the President of Ingalls is prejudicial to a proper business relationship between the Navy and the shipyard. In my experience, no other contractor has treated the Government in this manner. Both the General Manager, Electric Boat Division, General Dynamics Corporation and the President, Newport News Shipbuilding and Dry Dock Company attend formal meetings with the Supervisors of Shipbuilding at their respective shipyards to respond to financial, contractual, and management issues raised by the Navy; so should the President of Ingalls. If the Navy gives in at Ingalls, its position will be undermined at other shipyards

6. Since the President of Ingalls continues to be uncooperative in this matter, I recommend that you notify the Chief of Naval Material. The Navy should raise this issue formally with the Chairman of the Board of Litton Industries to obtain his agreement that meetings be held between the Supervisor and the President of Ingalls at the request of the Supervisor without the conditions set forth by the President of Ingalls.

7. I would appreciate being advised of what action you take in this regard.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Installations and Logistics)

Chief of Naval Material

Supervisor of Shipbuilding,
Pascagoula, Mississippi

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
Ser 08H-7781

2 0 AUG 1973

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATION AND LOGISTICS)

Subj: Compliance with the requirements of P.L. 87-653 (Truth-in-Negotiations Act)

Encl: (1) Memorandum for Deputy Chief of Naval Material (Procurement and Production) from Deputy Commander for Contracts, Naval Ship Systems Command dated 10 August 1973
(2) Ltr from VADM H. G. Rickover to Senator William Proxmire dtd May 28, 1970

1. Your memorandum dated 5 July 1973 to the Deputy Chief of Naval Material (Procurement and Production) granted a waiver of the requirements of the Truth-in-Negotiations Act for a procurement from the Ladish Company of forgings required in manufacture of a nuclear propulsion component. Your memorandum also stated that no further waivers will be granted for Ladish until a plan for resolving the problem with Ladish is presented to you.

2. By memorandum dated 10 August 1973, enclosure (1), The Deputy Commander for Contracts, Naval Ship Systems Command (NAVSHIPS) outlines the NAVSHIPS position in this matter to the Naval Material Command (NAVMAT). NAVSHIPS concludes that the problem of obtaining compliance with the act extends throughout the forging industry and requests NAVMAT assistance in dealing with the general problem. NAVSHIPS suggests that the similarity of positions taken by suppliers in the forging industry indicates that the suppliers may be engaged in a coordinated effort to circumvent the requirements of the Truth-in-Negotiations Act.

3. I concur in the NAVSHIPS position. As I pointed out in enclosure (2), the problem of obtaining compliance with the Act is not confined to the forging industry. In several other industries, including computer manufacturers and suppliers of raw material such as steel and nickel, suppliers do not provide certified cost or pricing data required by the Act. However, for reasons which I cannot understand, my program seems to be unique in recognizing and reporting the problem. For example, 12 of the 14 waivers granted by your office in the last 18 months were for my program. I find it difficult to believe that others do not have the same problem in obtaining compliance with the Act since products such as computers, steel and forgings are basic to most military hardware. I can only conclude that the requirements of the Act are not being enforced in other defense programs.

Ser 08H-7781

4. Since various industries appear to have taken a united position in non-compliance with the Truth-in-Negotiations Act, the problem of obtaining compliance must be approached on a Navy-wide or DOD-wide basis with the industries involved. In this regard, I recommend that the following specific steps be taken:

a. The Navy should advise the Office of the Secretary of Defense of the problems it is having in obtaining compliance with the Truth-in-Negotiations Act and request assistance in raising this problem in behalf of the Navy and the other military services with the industries and companies involved.

b. The Navy should strengthen its procedures to ensure that its contracting officers and contract administrators obtain certified cost and pricing data where required from all segments of defense industry or report the circumstances to higher authority as required by the Armed Services Procurement Regulation.

c. The Navy should request investigation by the Federal Trade Commission or the Department of Justice, to determine whether in arriving at industry-wide decisions not to comply with the Truth-in-Negotiations Act, the firms involved have violated federal statutes.

5. I would appreciate being informed of what action you take in this regard.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
024:CTS:mco
4280
Ser 607-024
10 AUG 1973

MEMORANDUM FOR DEPUTY CHIEF OF NAVAL MATERIAL (PROCUREMENT AND PRODUCTION)

Subj: Compliance with the requirements of Public Law 87-653 (Truth-in-Negotiations Act) by the Ladish Company

Ref: (a) NAVMAT ltr MAT-0212:KAP of 12 July 1973

1. Purpose. This memorandum responds to reference (a) which requests Naval Ship Systems Command (NAVSHIPS) input for a response to the Assistant Secretary of the Navy (Installation and Logistics) (ASN(I&L)) concerning the problem of obtaining certified cost or pricing data from the Ladish Company. This memorandum responds to the Secretary's specific request for identification and evaluation of alternatives in the Ladish situation and, in addition, places the Ladish situation in an overall perspective of similar problems with other forging suppliers. Finally, assistance is requested in obtaining compliance with P.L. 87-653 by Ladish and other forging suppliers.

2. Background.

a. For the last four years, Ladish has declined to provide certified cost or pricing data on non-competitive fixed price procurement actions. As a result, seven waivers of the requirement for such certified data have had to be granted. Ladish currently is taking the position that the risk Ladish would assume in certifying such data on fixed price contracts would be too great because its accounting system is not adequate for accumulation of the data.

b. Throughout the period during which waivers of the requirement for certified data have been granted for procurements from Ladish, extensive efforts have been made by NAVSHIPS and its prime contractors and by NAVMAT to obtain certified data where required. The most recent effort in this regard was made in May and June of this year when NAVSHIPS met with Ladish top management based on results of a General Accounting Office (GAO) review of Ladish requested by NAVMAT. The GAO review confirmed the adequacy of Ladish's accounting system for segregation of costs and submission of certified cost or pricing data. Further, the GAO review reports high profits on Navy forging orders (40.1 percent on one major forging type).

c. None of the efforts cited above has been successful. In connection with the last procurement, Ladish agreed to review its overall position in this matter. However, Ladish is almost two months late in submitting their response and states they will not respond before mid-August. Based on past experience, NAVSHIPS is not optimistic that Ladish will agree to provide certified cost and pricing data on future orders.

d. The position taken by Ladish is by no means unique in NAVSHIPS experience. During the past three years approximately 20 procurements for the Naval Nuclear Propulsion Program have required waivers of the requirement for certified cost or pricing data. Most of these were in connection with forging procurements. By obtaining the initial order for a particular type of forging a supplier can recover the cost of special tools, dies and fixtures. This gives him a substantial competitive advantage in follow-on procurements. Although these problems obviously affect other segments of defense procurement, procurement officials do not seem to be reporting these problems to higher authority as required by the Armed Services Procurement Regulation.

3. Discussion and Alternatives. Considering the Ladish problem in isolation from the general problem of compliance with the Act by forging vendors, three alternatives have been explored:

a. Use of cost-type subcontracts. Ladish will provide certified cost or pricing data on cost-type subcontracts. Ladish states that they are willing to accept the risk of defective cost or pricing data in this contract type since their risk would be limited to a reduction in fee and the Government would assume risk of cost overruns. NAVSHIPS considers that the small risk in producing these forgings does not warrant use of a cost reimbursement contract; in most cases, Ladish has delivered similar items under previous procurements; this makes uncertainties minimal and dictates the use of fixed price contract types. The alleged high profits realized by Ladish on past orders confirm this judgement. Further, forgings are sub-tier procurements under fixed price orders with component subcontractors. Use of a cost-type contract would result in the Government, instead of the component manufacturer and his subcontractor, assuming the financial risk and responsibility to ensure the forgings are technically adequate. The compromise of technical responsibility and the difficulty of properly administering cost-type contracts at the third tier is too great a concession for obtaining token compliance with the Act. Moreover, the precedent of using cost-type orders to obtain compliance with the Act could result in demands from other contractors for similar concessions in assuming financial risk and technical responsibility. From NAVSHIPS view, the use of cost-type contracts/subcontracts is not a viable alternative.

b. Development of alternate sources to provide competition on forgings where Ladish currently is sole source. This alternative has been pursued on two major forgings for which Ladish has been sole source. Quotations were received from Wyman-Gordon Company in July 1973 in which proposed recurring costs (cost per forging) are within a competitive range of Ladish; however, one-time costs for tooling (i.e., forging dies) are significant. It is unlikely that a large investment in one-time charges would be recovered through the resulting price competition. NAVSHIPS has been unwilling to incur large one-time charges to a second source solely for the purpose of creating a situation where Ladish could be excused from providing certified cost and pricing data. NAVSHIPS considers such action is not consistent with the intent of P.L. 87-653. Moreover, although the Wyman-Gordon proposals cover two of the major forging types on which Ladish is now sole source, there are other types of forgings for which adequate competition still would not exist. NAVSHIPS is continuing to pursue, through its prime contractors, negotiations with Wyman-Gordon to see whether one-time costs could be reduced to the point that future savings would offset the initial investment in obtaining a second supplier. Even if this effort is successful, it will not solve the basic problem of Ladish refusal to provide certified cost or pricing data where required by the Act. Moreover, NAVSHIPS should not be put into the position of paying a premium to circumvent the Ladish refusal to provide certified cost and pricing data required by the Truth-in-Negotiations Act.

c. Continue to exert pressure on Ladish for full compliance with P.L. 87-653. As noted above, NAVSHIPS has attempted to obtain Ladish agreement to comply with P.L. 87-653 through Ladish top management and its prime contractors and through meetings between NAVSHIPS and Ladish. NAVMAT assisted in this effort by meeting with Ladish officials in connection with past procurements and by obtaining the GAO review of Ladish. To date these efforts have not resulted in compliance by Ladish. Later this month NAVSHIPS expects to receive the official Ladish position with regard to their willingness to comply with the Truth-in-Negotiations Act. You will be advised of the Ladish response. NAVSHIPS will continue to seek compliance from Ladish but the history of such efforts is not promising.

4. Conclusion and Recommendations for Further Action. NAVSHIPS considers that neither the Ladish problem nor the refusal of other forging suppliers to provide certified cost or pricing data will be resolved at the NAVSHIPS level. There are some piecemeal actions--identified above--which at best would defer or mask the problem or which would compromise procurement and technical integrity. However, in the long range, the problem of refusal to comply with the requirements of the Act is broader than a single vendor, or a single type of forging. Judging from the similar positions taken by suppliers in the forging industry, it appears that the suppliers may be engaged in a coordinated effort to circumvent the requirements of the Truth-in-Negotiations Act. Thus it is unlikely that the problem will be

resolved unless it is dealt with on a Navy-wide or DOD-wide basis with the industry. In this regard, NAVSHIPS recommends that the Navy seek assistance as appropriate from the Department of Defense, Federal Trade Commission or the Department of Justice, to obtain compliance with the Truth-in-Negotiations Act.

E. E. RENFRO
Rear Admiral, Supply Corps, USN
Deputy Commander for Contracts

UNITED STATES
ATOMIC ENERGY COMMISSION
WASHINGTON, D.C. 20545

May 28, 1970

The Honorable William Proxmire
U. S. Senate
Washington, D. C.

Dear Senator Proxmire,

On May 1, 1970, you sent me copies of your March 17, 1970 letter to the Secretary of Defense and the Defense Department's response dated April 21, 1970. Your March 17th letter raised several questions concerning the lack of industry compliance with the Truth-in-Negotiations Act. The questions were based on my testimony and that of other witnesses before the Joint Economic Committee. Your May 1st letter asked me to comment on the Defense Department's official response.

I can appreciate your concern. The Defense Department's response appears inconsistent with testimony I have given before various Congressional committees, including your own. I have testified on several occasions that the Truth-in-Negotiations Act has not been implemented effectively by the Department of Defense and that entire segments of industry, such as computer manufacturers, material suppliers, and others, appear to be taking a united stand in refusing to provide cost and pricing data required by the Act. The Department of Defense, however, responded that, generally speaking, defense contractors and subcontractors have provided cost or pricing data when required by Public Law 87-653 except in selected cases; that, with the exception of two firms, the Department does not know of any industries or companies that refuse across-the-board to provide cost and pricing data; and that since the passage of Public Law 87-653, the Department of Defense has entered into well over 100 thousand transactions which were subject to the Act with only a minuscule number of waivers--all of which were reviewed at high levels in accordance with administrative procedures.

The Department of Defense also stated it was always seeking improved methods of administering the Truth-in-Negotiations Act; that a task group had been recently created to study alleged contractor resistance in supplying cost and pricing data in specific instences; and that the Department would take actions as necessary to improve its implementation of this law.

In stating that only a small number of waivers to the Truth-in-Negotiations Act have been granted, the implication is that all but this small number have been in compliance with the Act. The real issue, however, is the very large number of procurements, both prime contracts and subcontracts, where the law has not been complied with.

With regard to the Defense Department's response:

1. It is incomprehensible to me that defense procurement officials do not know of any industries or companies, other than the two specifically mentioned, that refuse across-the-board to provide cost and pricing data.

2. I believe, in light of the large segments of the defense industry that have been refusing to comply with the Truth-in-Negotiations Act, that the small number of waivers granted by the Defense Department is evidence it has failed to police the Act.

3. It appears that defense procurement officials have been placing too much reliance on management systems rather than actually checking into its procurement operations to identify problems. The establishment of a special task group at this late date to study "alleged contractor resistance to supplying cost or pricing data in specific instances" is indicative of the extent to which defense procurement officials have insulated themselves from actual procurement problems. Contractors in a number of industries have not been providing cost and pricing data since 1962--the year of enactment of the Truth-in-Negotiations Act.

The refusal of industries and companies to provide cost and pricing data in accordance with the Truth-in-Negotiations Act is known to officials of other Government agencies and to those involved in day-to-day procurement. I do not understand why the Defense Department does not face up to this problem. The following are three specific industries I have encountered that have not been complying with the requirements of the Truth-in-Negotiations Act:

a. Computer Industry

Computer suppliers have not been providing cost and pricing data to the Government as required by the Truth-in-Negotiations Act. Defense procurement officials should know of the problem; the Department of Defense has waived the Truth-in-Negotiations Act in connection with computer procurements. The issue has been well documented within the Government.

I pointed out this particular problem in testimony to Congress for the past several years. The Administrator of the General Services Administration also raised this issue in Congressional hearings and took it up with the General Accounting Office. The Atomic Energy Commission recognized this problem, too, and has been working with the Bureau of the Budget and the

General Services Administration to try to get it resolved. The problem is a matter of concern at the highest levels within the Atomic Energy Commission, as is evident from the following statement from a recent Atomic Energy Commission staff paper concerning failure of computer manufacturers to comply with the Truth-in-Negotiations Act:

> "In summary, the problem has been brought to the attention of the Congress and the General Accounting Office, to the attention of the Government's central ADPE procurement agency (GSA), and to the attention of the Bureau of the Budget. We have received a great deal of sympathy, but no solution. It would appear, therefore, that in the absence of getting the law amended either (1) to make submission of cost or pricing data mandatory, with penalties for failure to do so, or (2) to exempt computers from the present requirements of the law, we have no alternative but to continue waiving the requirement for cost or pricing data on a case-by-case basis."

b. Material Suppliers

Raw materials, particularly steel, are another example where an entire industry has not been required to comply with the Truth-in-Negotiations Act. Despite the many special purpose materials developed and procured strictly for military application, very few material suppliers have been required to provide cost or pricing data. Because material procurements often take place at the second, third, or lower level of subtier supplier, non-compliance with the Act in the area of material procurement is less apparent than it is in the case of computer procurements. However, a little checking would show that material suppliers generally do not provide cost and pricing data in accordance with the Act.

I found that in some cases considerable effort and ingenuity have gone into finding ways to circumvent the law. Here are some ways defense contractors and Government officials have been able for 8 years to procure materials from companies that refuse to comply with the Truth-in-Negotiations Act without having to obtain an official waiver of the law:

1. Determine that two or three bids constitute adequate competition regardless of the circumstances.

   The Truth-in-Negotiations Act provides that supplier cost and pricing data are not required if the procuring activity considers competition to be adequate. Since this judgment is often based on subjective and intangible factors, it is subject to considerable abuse.

Procurement of HY 80 and HY 100 armor plate for shipbuilding is a good example. These specialty steels were developed at Government expense and are used almost exclusively in the construction of nuclear submarines and other naval vessels. In 1965 the General Accounting Office issued a report on Navy procurement of HY 80 steel pointing out that the limited competition available did not insure reasonable prices; the two suppliers were making profits of 14 to 27%. The Navy replied that, in future, the Navy and its prime contractors would discontinue procurement of this material by formal advertising and would obtain certified cost and pricing data as required by the Truth-in-Negotiations Act.

In December, 1969, I pointed out to Navy officials that shipbuilders had not been obtaining cost and pricing data on HY 80 and HY 100 steel procurements despite the assurances the Navy had made to the General Accounting Office. Further, it turned out that responsibility for direct Navy procurements of this material had been assigned to the Defense Industrial Supply Center. This Center had not insisted on cost and pricing data either. The shipyards and the Defense Industrial Supply Center had decided that competition was adequate and that no cost and pricing data were required.

The fact is that no one has yet been able to obtain the steel companies' agreement to provide such data. The Navy is now working on this problem; I understand that as of this date all the steel suppliers still refuse to provide cost and pricing data on these procurements.

2. Conclude that the price is based on standard catalog prices.

The Truth-in-Negotiations Act provides that supplier cost and pricing data need not be obtained where prices are negotiated based on established catalog or market prices of commercial items sold in substantial quantities to the general public. Material suppliers, therefore, establish standard catalog prices for the basic material, and separate add-on factors for additional specification requirements. The result is that prices for specialty materials peculiar to defense equipment can be "based on established catalog or market prices of commercial items sold in substantial quantities to the general public". The Truth-in-Negotiations Act is thereby avoided.

3. Break procurements into small orders that do not exceed $100,000.

Procurements under $100,000 are exempt from the Truth-in-Negotiations Act. As a result, some contractors divide their total requirements into several smaller orders to bypass the Truth-in-Negotiations Act. I found that a shipbuilder recently procured on a sole-source basis $3.4 million of specialty steel for a single ship under 1200 separate purchase orders, none of which exceeded $100,000.

4. Disregard the law and chance that no one in the Government will find out.

This tends to be encountered more in the second or third tier subcontract level. However, in 1969, I found that two of the Navy's major shipbuilders, most of whose government business is under Navy prime contracts, had not implemented the Truth-in-Negotiations Act seven years after its enactment.

c. Forging Suppliers

For years the Department of Defense and its contractors have been buying specialty forgings without obtaining cost and pricing data from forging suppliers. The forgings are bought on the basis that there is "adequate competition" for such items and that this "competition" can be relied upon to insure reasonable prices to the government; therefore cost and pricing data are not required. In fact, there is not usually real competition for such forgings. What limited competition there is usually is not adequate to insure reasonable prices. For example, frequently only one or two suppliers are able to make the item, and often one supplier has a significant competitive advantage over the others in the form of production facilities or by virtue of having obtained the initial order which paid for the tools, dies and fixtures needed for the forgings. Often there is only one source.

I recently brought four specific cases involving sole-source procurements to the attention of senior defense procurement officials. Since sole-source procurement were involved, there was no question as to whether or not competition was adequate; cost and pricing data were clearly required in these procurements.

In these four cases, each of the four forging companies stated that its policy was to not provide cost and pricing data. Navy procurement officials had to devote considerable time and effort trying to convince these companies—8 years after enactment of the Truth-in-Negotiations Act—that they should start complying with the law. The results were less than satisfactory but they were the best the Navy could obtain in the circumstances without further jeopardizing project schedules. The following is a summary:

SUPPLIER	TIME SPENT TRYING TO GET AGREEMENT TO PROVIDE COST DATA	FINAL RESOLUTION
Forging Supplier A	2 months	Forging Supplier A refused to provide cost data. The Assistant Secretary of the Navy had to waive the law to avoid delay to an important project.
Forging Supplier B	6 months	Forging Supplier B finally agreed to provide cost data, on this one procurement only, on the basis that the Navy could get no bids from another source. The cost data showed an unsupported contingency factor such that the supplier stands to make a 23% profit on this order. The supplier, however, has refused to reduce his price.
Forging Supplier C	7 months	The Government had to agree to a cost-type contract rather than a fixed-price contract before Forging Supplier C would agree to provide cost and pricing data on this procurement. The Government is left with the problem of administering a cost-type contract through two higher tiers of contractors, one of which is operating under a fixed price order. This is not an acceptable long-run solution to the problem.
Forging Supplier D	7 months	Shortly after a member of Forging Supplier D's management was appointed to the Holifield Commission on Government Procurement, the company provided cost data. These data are being audited. Since then, however, Forging Supplier D has been unable to obtain the required cost and pricing data from its traditional steel supplier on an order for steel to be used in the Navy forgings. Forging Supplier D is now seeking a bid from another steel supplier so that his lower tier procurement of steel can be classified "competitive".

I find it hard to believe that the problems I have pointed out are unique to my area of responsibility which covers but a small fraction of Defense Department procurement. Computers, steel, and forgings are basic to most military hardware. Therefore, I can only conclude that a general laxity in the implementation and enforcement of the Truth-in-Negotiations Act pervades the defense procurement establishment. It would appear to me that, if the issue were thoroughly investigated, it would be found that the problem is endemic throughout defense procurement. Of course, if you don't follow the facts too closely you won't have dirt kicked in your face.

As I have testified many times, I believe the Department of Defense should face up to the lack of effective competition in contracts and subcontracts for complex defense equipment and implement the Truth-in-Negotiations Act. Moreover, I believe it is wrong to apply a double standard such that some favored industries and companies are allowed to avoid the Truth-in-Negotiations Act, while others must comply. I believe you will find that my testimony to this effect is based on fact.

I trust the above is responsive to your letter.

Respectfully,

H. G. Rickover

H. G. RICKOVER

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-2060

5 SEP 1973

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY (INSTALLATIONS AND LOGISTICS)

Subj: Cost Control at Newport News Shipbuilding and Dry Dock Company

Encl: (1) Chronology regarding Navy Efforts to Improve Cost Control on Navy Contracts with Newport News Shipbuilding and Dry Dock Company

1. I understand that on 6 September 1973 you are scheduled to meet with Newport News Shipbuilding and Dry Dock Company officials regarding cost control and cost reporting requirements on Navy shipbuilding contracts. I am forwarding herewith a chronology of significant events pertaining to this problem, enclosure (1), to assist you in preparing for that meeting.

2. Over four years ago, in a letter to your predecessor dated April 30, 1969, I pointed out fundamental deficiencies in Newport News' cost control practices. As noted in the attached chronology, subsequent independent reviews by Naval Ship Systems Command and Naval Material Command representatives, a special study by the Assistant Secretary of the Navy (Financial Management), and audits by the Defense Contract Audit Agency and by the General Accounting Office have confirmed and elaborated upon these deficiencies. In response to these reviews, Newport News has presented plans for improved cost control systems at the shipyard. However, little progress has been made in implementing these improvements. The improvements always seem to be scheduled for full implementation "sometime in the future".

3. The deficiencies identified at Newport News are basic. In a letter to the President of Newport News dated March 26, 1971, the Commander, Naval Ship Systems Command summarized the deficiencies as follows:

> "Labor costs are not related to physical progress by cost account, work package, or other common base in a way that identifies potential overruns and the causes therefor in time to take corrective action."
>
> "Budgets and incentives at the working level are not related to contract price. Labor incentive targets are assigned without considering direct labor budgets. It is possible to meet all working level budgets and still overrun a contract because contract budgeting stops at the department level."
>
> "Material costs are not related to budgets in a way that identifies potential overruns or underruns and the causes therefor as work progresses."
>
> "Budgets are not updated to reflect changes, rework, etc., and thus cannot be an effective check on performance."

"Existing cost control reports do not provide for prompt identification of budget variances and the causes therefor. Moreover, Newport News apparently does not have procedures for the evaluation of variances or the determination of corrective action. Finally, there is no formal system to ensure that necessary corrective action is taken."

"Newport News does not generate cost reports sufficient for Newport News management and the Navy to identify variances from budgets, the cause of such variances or the corrective action needed."

"Cost charging system is extremely flexible. Over 25% of direct charges are preallocated among contracts. No controls over whether cost is to be charged directly or to overhead."

4. In a letter to COMNAVSHIPS dated June 21, 1971, the President of Newport News acknowledged that improvements were necessary to the cost control system and stated that they had under development a "space-oriented" ship cost control system which the company believed would provide improved cost control. Based on subsequent discussions with the Navy, the shipyard's "space-oriented" system was to be implemented, on a trial basis, to control costs of work during construction of the DLGN 38. The DLGN 38 contract therefore contains a provision requiring that Newport News report budgets, costs and variances at the cost account level; provide an explanation of these variances; and identify the action to be taken to preclude overruns. This reporting system was never implemented by the company. When this issue was raised by the Navy, shipyard management stated that the company was not committed to provide any more information on the DLGN 38 contract than its existing accounting system generated.

5. During 1972 and 1973 Newport News spent and allocated to Navy contracts more than $400,000 in development of its proposed new cost control system. However, in recent discussions with shipyard cost control personnel, my representative was told that Newport News management had decided against implementing key portions of the "space-oriented" system at this time. Thus it appears that the company intends to continue to rely for labor cost control on the existing system which the Government has found to be inadequate.

6. The company's intent in this regard is also apparent from its response to the request for proposal for the FY 73, FY 74 SSN 688 Class submarines. This request for proposal requires contractors to implement cost control systems which meet the general criteria of Department of Defense Instruction 7000.2. Newport News proposed an improved material cost control system for this contract, but proposed to use the present inadequate labor cost control system.

7. That the company has not corrected these deficiencies and apparently has no plans to correct them in the near future, are matters I recommend you take up with Newport News officials. Newport News management will doubtless claim that their existing system already provides adequate control; that attempts at improved controls will not be cost effective; and that the reason for contract

cost overruns is due to Navy actions, not the lack of internal company controls. However, in view of the extensive deficiencies that have been identified in Newport News' cost control systems, and the fact that cost overruns are projected on many different contracts, this is not a credible argument.

8. There is also an access to records problem with Newport News that bears on the subject of cost control. I understand that the company has been denying Government representatives access to certain records and analyses of the reasons actual costs vary from budgets. Since government work is predominant at Newport News; since Navy contracts with the company are almost all cost type or fixed price incentive type contracts where the Government shares heavily in cost overruns; and because the Navy must pay the cost of the company budget systems, the Government should have access to these records. Otherwise, it cannot evaluate the effectiveness of these budget systems.

9. I urge you to familiarize yourself with the background of this problem summarized in enclosure (1) prior to your meeting with Newport News officials. I recommend that you obtain a firm commitment from the President of Newport News--or, if necessary, from Tenneco--to correct the deficiencies that have been identified in the Newport News cost control system, and obtain his agreement to provide Government access to budgetary and other financial records that on-site Government representatives need to evaluate the effectiveness of the company's cost control efforts.

10. I would appreciate being kept informed of progress in this matter. If I can be of further assistance, please let me know.

H. G. Rickover
H. G. Rickover

Copy to:
Assistant Secretary of the Navy
 (Financial Management)
Chief of Naval Material
Commander, Naval Ship Systems Command

CHRONOLOGY REGARDING NAVY EFFORTS TO IMPROVE COST CONTROL ON NAVY CONTRACTS WITH NEWPORT NEWS SHIPBUILDING AND DRY DOCK COMPANY

April, 1969 NAVSHIPS 08 memorandum to ASN (I&L) dated 30 April 1969 points out major deficiencies in controls over shipbuilding costs at Newport News. The memo states in part:

a. Newport News budget control system does not effectively use cost estimates developed for negotiating ship prices as budgets for controlling actual costs during ship construction. Further under the present system, it is possible to meet all working level budgets and still overrun the ship construction contract.

b. About 50% of all Newport News construction work is performed without any form of cost budgeting.

c. About 70% of ship construction costs are allocated to the various ship contracts by shop working level supervisors.

The report concludes that the present Newport News cost control system cannot be relied upon to adequately control costs under shipbuilding contracts.

June 1969 Supervisor of Shipbuilding (SUPSHIPS) Newport News letter dated 3 June 1969 summarizes to the shipyard the deficiencies in the shipyard's cost control system as identified in DCAA and Navy reviews. This letter raised the issues brought out in the NAVSHIPS 08 report of April 1969. The letter requests that the company implement on a priority basis effective cost controls for construction of DLGN 36 and 37, CVAN 68 and other contracts where the Government bears risk of cost overruns.

August 1969 Newport News' reply dated 6 August 1969 to the SUPSHIPS letter of June 3, 1969 states that the company acknowledges that their present cost control system has deficiencies but disagrees with the Navy finding that there is evidence of lack of cost controls.

August 1969 SUPSHIPS letter dated 29 August 1969 advises COMNAVSHIPS that the Newport News August reply is unresponsive. The letter states that shipyard top management has stated that the Company lacks visibility on the cost of doing specific packages of work.

September 1969 SHIPS 08 memorandum to COMNAVSHIPS dated 23 September 1969 points out that nothing has been done to improve cost controls at Newport News since April 1969. The memorandum also points out that the shipyard has again deferred an improved cost budgeting system and that the improved system may not be put into effect at all.

November 1969 COMNAVSHIPS letter to ASN (I&L) dtd 23 November 1969 forwards the results of his review of Newport News cost controls. His review team reports that the shipyard has a "reasonably good cost control system". However, the review team recommends certain improvements and assigns the Supervisor of Shipbuilding to monitor implementation of these improvements.

February 1970 NAVSHIPS 08 memorandum to COMNAVSHIPS dated 16 February 1970 points out the need to establish cost controls for construction of CVAN 68. It points out that because CVAN 68 construction work had been in progress for two years it would not be possible to develop a reliable cost control system which related work as performed under the production control system to budgeted costs developed from a negotiated ship construction price. Instead emphasis will have to be placed on developing a cost reporting system that provides status of labor costs. These costs will then have to be analyzed against the progress of the work in order to ferret out potential problems.

February 1970 NAVSHIPS 08 memo to COMNAVSHIPS dated 16 February 1970 comments as follows on the findings of the NAVSHIPS November 1969 review: "I do not understand how Newport News cost control system can be classed "reasonably good" when cost budgets do not and cannot act as a prompt and effective check on work actually being performed in shops and on waterfront. Under the Newport News system it is impossible to identify specific cost overruns in a timely manner or make effective use of budgetary controls to safeguard against mischarging of costs.

January, April, May, June 1970 Defense Contract Audit Agency reports that its reviews indicate a lack of internal Newport News controls over labor costs and that the shipyards production controls are not related to cost budget controls.

July 1970 NAVMAT issues a draft report of its study regarding segregation of change order costs. The report points out that accounting for changes would be facilitated if shipbuilders budgeted and accounted for costs of individual work packages. (Report finally issued December 1970.)

August 1970 Senator Proxmire asks the General Accounting Office to look into VADM Rickover's charges regarding the lack of cost controls at the Navy's major shipyard.

September 1970 The Assistant Secretary of the Navy (Financial Management) reports the results of his study of the causes for and the extent of cost accounting problems at Newport News which had been requested by the Vice Chief of Naval Operations in December 1969. The report lists 16 major deficiencies in the Newport News cost control system and notes that the Navy has not levied the necessary specific requirements on the contractor to provide effective control. The deficiencies are:

- "Newport News Shipbuilding and Dry Dock Company does not have an integrated management control system. It has a "Program Control System" which has four separate subsystems that are not capable of relating to each other.
- "The system is not capable of relating costs with planned performance; nor reporting accurate status of physical progress.

- "Labor budgets are developed at too high a level of work definition for effective management control.
- "Labor budgets are not related to significant events, milestones, or specific time spans.
- "Variances between actual performance and budgets cannot be explained in a timely manner, due to non-compatibility of production and cost subsystems.
- "Cost growth problems cannot be identified early enough to permit timely corrective action.
- "Newport News Shipbuilding and Dry Dock Company work breakdown structure is not compatible with MIL-STD-881, therefore, company will have problems when DODI 7000.2 is implemented.
- "Material budgets are not used for cost control purposes after the material is introduced into the production process.
- "Change order identity is lost when incorporated in the production cycle; therefore, cost of changes are lost and the impact on work schedule cannot be fully identified.
- "Responsibility for overtime costs is not identified to either the contractor (contractor inefficiencies) or to the Navy (added Navy requirements).
- "Overhead budgets are prepared for Newport News Shipbuilding and Dry Dock Company Departments. These budgets are not meaningful to Navy management for control and evaluation of contract costs.
- "Costs for rework are virtually impossible to segregate and identify. Therefore, product costs and future estimates are overstated by the amount of rework.
- "Incentive pay targets are not coordinated with direct labor budgets.
- "Incentive payments can be paid for rework as well as regular work thus increasing costs to the Navy.
- "Newport News Shipbuilding and Dry Dock Company billings cannot be related to either (1) change orders, or (2) specific fund authorizations.
- "The study also revealed several internal Navy problems: Multiple funding for ship construction and overhaul/repair work and split management controls have resulted in a number of activities performing accounting functions related to a single contract.

September 1970 CVAN 68, 69 construction contract awarded. The contract requires cost reporting which conforms to Newport News current internal system of cost reporting and budget control for each new ship. It also requires that as the shipyard develops new reports, these reports may be substituted for reports outlined in the contract. For the nuclear propulsion plant Newport News is also required to identify variances between current total estimated cost and contract amounts and explain any case where actual costs exceed budgets by 10% of any work item.

October 1970 NAVSHIPS 08 memorandum dated 13 October to COMNAVSHIPS points out his concern over the Navy's lack of progress in correcting cost control deficiencies at Newport News. The memorandum states in part:

> "Government representatives have made several reviews of Newport News' cost control procedures. The resident defense auditor has issued three reports this year recommending that the Newport News budget control and production control systems be integrated to provide reliable cost control. A Navy study is considering the cost control problem in connection with a general review of shipyard cost accounting issues requested by the Assistant Secretary of the Navy for Financial Management. However, the Navy has not reached agreement with Newport News on a schedule for developing and implementing an effective cost control system."

January 1971 NAVSHIPS forwards NAVSHIPS 08's reports on Newport News Cost Controls to Newport News for review and requests that the shipyard offer their views as to what the major cost control problems are and what should be done to correct them.

January 1971 The SSN 688 construction contract awarded. Article 8(c) requires a quarterly cost report that provides for cost category reporting in accordance with the work breakdown structure, the cost incurred, cumulative to date, projected to completion showing budgeted amount and any variance between the projected to completion and the budgeted amount.

February 1971 Newport News responds to NAVSHIPS January 1971 request and provides a status of shipyard's action to improve cost controls.

March 1971 By letter dated 26 March 1971, NAVSHIPS provides Newport News with a list of specific deficiencies in its cost control system. This list is stated as representing a consolidated NAVSHIPS opinion of the yards' current cost control system. The deficiencies are:

1. Labor costs are not related to physical progress by cost account, work package, or other common base in a way that identifies potential overruns and the causes therefor in time to take corrective action.
2. No budgets and incentives at the working level. Labor incentive targets are assigned without considering direct labor budgets. It is possible to meet all working level budgets and still overrun a contract because contract budgeting stops at the department level.

3. Material costs are not related to budgets in a way that identifies potential overruns or underruns and the causes therefor as work progresses.

4. Budgets are not updated to reflect changes, rework, etc., and thus cannot be an effective check on performance.

5. Existing cost control reports do not provide for prompt identification of budget variances and the causes therefor. Moreover, Newport News apparently does not have procedures for the evaluation of variances or the determination of corrective action. Finally, there is no formal system to ensure that necessary corrective action is taken.

6. Newport News does not generate cost reports sufficient for Newport News management and the Navy to identify variances from budgets, the cause of such variances or the corrective action needed.

7. Cost charging system is extremely flexible. Over 25% of direct charges are preallocated among contracts. No controls over whether cost is to be charged directly or to overhead.

The NAVSHIPS letter also forwards a set of cost control criteria considered necessary for an effective cost control system and requests that Newport News evaluate its system being developed against the criteria. The letter states that NAVSHIPS would like to resolve any differences and obtain agreement that the system being developed will satisfy the Navy criteria, and a time phased plan developed by which Newport News plans to implement the system.

June 1971 President of Newport News provides his comments on NAVSHIPS March 1971 letter and cost control criteria in a letter to COMNAVSHIPS on 21 June 1971. This letter outlines the cost control improvements the company has under development for use on the upcoming DLGN 38 contract. The letter states that..,"we are confident that our system will be in agreement with logical interpretations of the cost control criteria." The Supervisor advises NAVSHIPS that he considers the shipyard's approach to be logical and constructive. The Supervisor proposes a series of meetings with the shipyard for the purpose of establishing milestone and implementation goals."

August 1971 SUPSHIPS requests that NAVSHIPS review Newport News new cost control system improvements prior to approval for implementation on the pending DLGN 38 contract.

August - October 1971 The President of Newport News briefs Navy officials on the status of the shipyard's implementation of improved cost controls on ship construction. The company outlines its plans for the so-called "space control system." NAVSHIPS never responded formally to these briefings or to the Newport News August letter commenting on the NAVSHIPS cost control criteria.

November 1971 SHIPS 08 memo to SHIPS 05 dated 12 November 1971 points out deficiencies in shipyard's plans for cost control improvements. The memorandum recommends that NAVSHIPS obtain from Newport News a detailed statement of exactly how they intend to comply with each item in the NAVSHIPS Cost Control criteria for shipbuilding contracts and obtain a firm plan and time schedule for implementing the needed changes.

December 1971 The DLGN 38 contract is awarded. Clause 36 of the contract requires Newport News to maintain a management control system to ensure effective cost control. It specifies:

"The Contractor shall submit to the Contracting Officer a quarterly cost report for the work covered by this Contract. The report format shall provide for cost category reporting of incurred, committed and projected costs in accordance with the Contractor's normal accounting system and consistent with the work breakdown structure included in the Contractor's pricing proposal for this contract. As a minimum the report format shall provide the following information for each cost category broken down into labor hours, labor dollars, and material dollars.

(a) budget amount based on contract price (target price)

(b) actual costs incurred and committed to date

(c) percentage of physical completion

(d) estimated cost to complete based on incurred costs and status of physical completion

(e) variance between current total estimated cost and budget amount

(f) explanation of changes in budget amounts

(g) explanation of variances identified in (e) above. Such explanations shall include corrective action to be taken to preclude overruns and identification of the individual designated responsible for taking corrective action.

January 1972 The GAO reports the results of its review of Newport News operations as requested by Senator Proxmire. The GAO report states "We believe that the current budget and cost system of the Contractor does not effectively insure proper control of costs on Navy ships."

September 1972 Newport News issues a document entitled "Cost Schedule Control Manual for the DLGN 38 Contract." Its purpose, according to the manual, is to establish the basis for a revised cost schedule control system to be followed for construction of DLGN 38.

October 1972 A Navy/Newport News conference report on SSN 688 Class construction cost reports dated 27 October 1972 concluded that Newport News' cost control system does not correct the deficiencies outlined in the 26 March 1971 NAVSHIPS Cost Control letter and recommends that Newport News take immediate management action to establish a cost control system which meets the general criteria necessary for effective control of costs.

December 1972 DCAA report dated 29 December 1972 on Newport News financial controls states that the Government is paying excessive and unnecessary costs due to the lack of effective financial control procedures.

August 1973 Newport News cost control personnel state that Newport News management has decided not to implement at this time key portions of the space control system. Without total implementation of the system, Newport News personnel will be unable to compare actual costs with budgeted costs and to determine reasons for any variances at the detailed level of work.

August 1973 Supervisor of Shipbuilding/Newport News management meeting is held to discuss the company's failure to comply with the DLGN 38 contract requirement regarding cost controls. Newport News responds that under the specific wording of the contract, Newport News is not committed to provide any more information on the DLGN 38 contract than its existing accounting generated.

August 1973 Mr. Bowers, Assistant Secretary of the Navy (Installations and Logistics) visits Newport News for a tour of the shipyard. The subject of Newport News cost control is brought up,

September 1973 A meeting is scheduled for 6 September 1973 for Newport News officials to discuss cost control with the Assistant Secretary of the Navy (Installations and Logistics).

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO

28 March 1974

MEMORANDUM FOR THE CHIEF OF NAVAL OPERATIONS

Subj: Interpretation of National Defense As Defined In The Defense Production Act For Purposes of Determining Eligibility of Products for Defense Priorities

Per your request of 27 March 1974 I am writing this memorandum to present my views regarding the memorandum from the Assistant Secretary of the Navy (Installations and Logistics), ASN(I&L), dated 26 March 1974, to the Assistant Secretary of Defense (Installations and Logistics), ASD(I&L). The ASN(I&L) memorandum recommends a broadened interpretation of national defense as defined in the Defense Production Act in order to justify recommending assignment of defense priorities for Very Large Crude Carriers (VLCC) of 380,000 DWT or larger, sometimes referred to as Ultra Large Crude Carriers (ULCC), to be constructed at the Todd Shipyard, Galveston, Texas.

In the fall of 1973 the Navy was asked by ASD(I&L) to comment on the applicability of defense priorities for the first VLCC of 380,000 DWT or larger, proposed for construction in the United States. At that time the Deputy Chief of Naval Operations (Logistics) concluded that such ships do not meet the criteria necessary for assignment of defense priority under the Defense Production Act. This position was based primarily on the large size, lack of maneuverability, and deep draft of these ships which, combined with the importance of their basic commercial mission, make it unlikely that they would be used in an activity directly related to military programs. Based on this position the ASN(I&L), in a memorandum of 27 November 1973 to ASD(I&L) recommended that the first four ships of this class not be granted priorities. The ASD(I&L) in a letter of 5 December 1973 to the Office of Preparedness concurred with the Navy recommendation, and this position was upheld by the Office of Preparedness in a letter dated 6 February 1974 following completion of their own consideration regarding priority for these ships.

When you and I met with the Secretary of Defense on 31 December 1973 one of the items we discussed was capacity for building nuclear warships. Following this meeting you directed the Commander, Naval Ship Systems Command (COMNAVSHIPS), to prepare a briefing on this subject. The resultant briefing was reviewed and approved by you, the Chief of Naval Material (CNM), the ASN(I&L), and the Secretary of the Navy. Portions of the briefing were presented by the Navy to the Deputy Secretary of Defense (DEPSECDEF), on 28 January 1974. One major point made in this briefing was that over the past decade the dollar value of shipbuilding contracts placed annually in the United States for merchant ships has increased from one-fourth the value of annual naval shipbuilding contracts being placed ten years ago, to where today the value of annual merchant ship contracts exceeds annual naval shipbuilding contracts. It was emphasized that naval ships are in competition with merchant ships for United States shipbuilding capacity and that the Navy is losing capacity in this competition. The briefing also spelled out the difference between qualification requirements for subsidies granted to merchant ships under the Merchant Marine Act and priorities assigned under the Defense Production Act. COMNAVSHIPS stressed in the briefing that the Navy had officially concluded that Liquified Natural Gas carriers (LNG's) and the large crude carriers of 380,000 DWT displacement do not meet the requirements to be eligible for assignment of defense priority. He also pointed out that ASD(I&L) had supported this Navy position in correspondence with the Office of Preparedness. One of the concluding recommendations of the briefing was that the Navy urge the Secretary of Defense to support strongly this Navy position on priorities.

However, the ASN(I&L) in his memorandum of 26 March 1974 to ASD(I&L) changed the Navy position to recommend defense priority for 380,000 DWT tankers to be built at the Todd Galveston yard based on his proposed "broadened interpretation of national defense." His broadened interpretation would extend the meaning of national defense, as defined in the Defense Production Act, to include:

a. Supplies critical to the nation in time of war and their means of transport.

b. Programs supported financially by the U.S. Government.

c. Programs affecting our continuing economic growth and prosperity.

The ASN(I&L) also stated that if the broadened interpretation were not concurred in, the prior recommended denial of priority must stand.

If the broadened interpretation of national defense recommended by the ASN(I&L) were adopted, the defense priorities system would inevitably be extended to a wide range of non-military programs which are critical to the nation in time of war, and/or qualify for Government subsidy, and/or affect our continuing economic growth and prosperity. This would reduce the protection of production for military programs intended by the Defense Production Act. Even with the present interpretation of programs eligible for defense priority; the Navy is currently experiencing increasing procurement lead times arising from shortages of material, components, and skilled labor. The longer lead times delay ship deliveries and increase costs. In this environment, to protect military programs it is even more important that the scope of programs assigned defense priorities not be broadened. I question whether the Navy and the Department of Defense may not already have gone beyond the intent of the Defense Production Act by supporting the assignment of defense priorities to non-military programs.

I am particularly concerned about the impact of commercial work on naval ships when defense priorities are assigned to commercial ships being built in yards on which the Navy depends for warship construction. In late 1972 COMNAVSHIPS and I attempted through the Joint MARAD/Navy Shipbuilding and Repair Committee to persuade the Assistant Secretary of Commerce for Maritime Affairs to enter into a mutual agreement with the Department of Defense that would resolve this problem in favor of Department of Defense work. The proposed agreement stated that whenever there is a conflict between the Defense Department and Maritime Administration shipbuilding contracts which are assigned defense priority, then these conflicts would be resolved so that work on Maritime Administration contracts would not interfere with performance of work required to meet commitments on Navy contracts, irrespective of the dates of placement of either the Navy or the Maritime Administration contracts. Subsequently, we were informed that the Department of Commerce had determined that neither the Navy nor the Maritime Administration had authority to enter into such an agreement. Instead the Navy would be required in each individual case of conflict to request special assistance from the Department of Commerce in accordance with established procedures.

The ASN(I&L) 26 March memorandum states that "if national defense is to be interpreted in this broader sense, then we must not do a disservice to naval vessels in construction at the same time," and that therefore "the approval of the Todd 380,000 DWT VLCC's should not be taken as a broad precedent." However, I do not see how the Department of Defense could establish a broad interpretation of national defense without establishing a broad precedent. Further, it would be very difficult for the people administering the defense priorities system to justify granting or denying priorities on a given product, based on whether or not the supplier is performing other military work at the same time. It would also lead to a situation whereby suppliers such as shipbuilders would soon realize that acceptance of Navy work would place them at a disadvantage relative to other contractors as regards to commercial work, thus further decreasing their incentive to do Navy work.

Because of the great importance of this matter to all Naval procurement programs, and because action taken on the ASN(I&L) 26 March memorandum can set a precedent for application to the procurement programs of other Services, I recommend you take this matter up with the Secretary of the Navy and the Secretary of Defense.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy
  (Installations and Logistics)
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Ship Systems Command

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D. C. 20360

IN REPLY REFER TO
08H-725
11 APR 1974

MEMORANDUM TO COMMANDER NAVAL SHIP SYSTEMS COMMAND

Subj: Deficiencies in Procurement of Material by Private Shipyards

Ref: (a) NAVSHIPS 08 memorandum to COMNAVSHIPS, Ser 08H-1438 of 14 April 1971
(b) Supervisor of Shipbuilding Newport News letter to COMNAVSHIPS, Ser 403-122 of 14 August 1972

1. In April 1971, I wrote to you about the higher than necessary prices being paid for nickel alloy products because of Newport News Shipbuilding and Dry Dock Company's practice of buying this material through distributors. Reference (a) pointed out that distributors for nickel alloy material provide little or none of the services ordinarily expected of a middleman such as stocking and delivering goods; acting as a liaison between the buyer and the manufacturer; billing customers; and receiving payment. Reference (a) reported that:

a. Material was not provided from the distributors' inventories; it was manufactured and shipped directly from the manufacturer represented by the distributor.

b. Shipyard questions regarding pricing, delivery and technical ordering data were in most cases resolved by the shipyard directly with the manufacturer, not the distributor.

c. Discrepant material received by the shipyard was returned directly to the manufacturer, not the distributor.

d. Manufacturers did not underbid their distributors. Two or three distributors often represented the same manufacturer and at times quoted identical prices. Whenever both the manufacturer and his distributor quoted on a shipyard purchase order, the manufacturer's price was either identical to or higher than the prices quoted by the distributor. Manufacturers on occasion even requested that the shipyard purchase materials from an area distributor in order that the distributors could receive the manufacturer's discount.

I estimated that the shipyard could save 5% to 15% of the cost of material if it purchased material directly from manufacturers and eliminated the markup to distributors in those cases where the distributors provided no meaningful services. Reference (a) recommended that NAVSHIPS take action that would preclude the shipyard from paying unnecessary distributor markups in the procurement of nickel alloy materials.

2. In response to my memorandum, the Supervisor of Shipbuilding at the request of NAVSHIPS conducted a review of Newport News' practice of purchasing nickel alloy material through distributors. His report, reference (b), confirmed my findings. According to reference (b):

a. A leading manufacturer of nickel alloy products sold through distributors not only to Newport News, but to Electric Boat, Bath Iron Works, Litton Industries, Portsmouth, Mare Island and Charleston Naval Shipyards, Defense Construction Supply Center, Ships Parts Control Center, and the Tennessee Valley Authority.

b. As verified by DCAA audit, distributors' markup rates varied from 3 to 20% with 20% as the objective.

c. The only services provided by distributors representing the nickel alloy manufacturer consisted of pricing and preparing invoices.

d. A principle distributor doing business with Newport News is Gas Equipment Engineers which is another subsidiary of Newport News' parent corporation, Tenneco.

e. Newport News at the Navy's request attempted to procure nickel alloy material from one manufacturer but was unsuccessful.

Reference (b) concluded that the distributor issue should be resolved on a Government-wide basis because it was not an issue unique to Newport News. Accordingly, the Supervisor recommended that NAVSHIPS take the lead and provide the coordination necessary to resolve this matter.

3. To my knowledge no further action has been taken by the Navy on this issue. Recently I asked my representatives at Newport News and Electric Boat to conduct follow up reviews to determine the status of shipyard procurement from distributors. They found:

a. In those cases where nickel alloy products are procured by Electric Boat and Newport News through distributors, these distributors provide little or no services that would justify paying the distributors markup. Moreover, the same pricing tactics used by manufacturers and distributors in 1971 still exist.

b. Distributors are not limited to nickel alloy products. They are also involved in selling such items as pipe, tubing and fittings, electrical equipment and lumber.

c. At Newport News the principle distributor continues to be Gas Equipment Engineers, a Tenneco-owned subsidiary.

d. The total amount of purchase orders placed with known distributors on current Navy contracts at Newport News and Electric Boat is over $10 million. It is reasonable to assume that 5-10% of this amount, or $500,000 to $1 million could have been saved if shipyards had been able to purchase this material directly from manufacturers at the same price they charged their distributors.

e. There was no evidence that the Navy had taken coordinated action to require the direct procurement of material from manufacturers.

4. In view of the high cost of naval ship construction, we should be doing everything possible to stop paying unnecessary costs. One high priority item should be the elimination of markups charged by middle men who perform no substantial or essential services. Therefore, I recommend you take immediate action to eliminate paying these kinds of distributor markups at both Navy and private shipyards. As this problem undoubtedly is endemic throughout defense procurement, I also recommend that NAVSHIPS bring this matter to the attention of higher officials within the Navy and the Department of Defense so that coordinated action can be taken to reduce the unnecessary additional costs caused by distributor markups on all defense procurement. Delay in obtaining corrective action will only lead to further unnecessary costs to the Government.

5. I would appreciate being advised of what action you take in this matter.

H. G. Rickover
H. G. Rickover

Copy:
Assistant Secretary of the Navy (Installations & Logistics)
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D C 20360

IN REPLY REFER TO
08H-732
17 JUN 1974

MEMORANDUM FOR COMMANDER, NAVAL SHIP SYSTEMS COMMAND

Subj: Contract Cost Data Reporting (CCDR)

Ref: (a) DODI 7000.11 of 5 September 1973
(b) NAVSHIPS 0542 Route Sheet of 3 April 1974
(c) Pending SECNAVINST 7000.XX of 5 November 1973
(d) Draft NAVMATINST of 19 February 1974

Encl: (1) My memorandum to CNM dtd 28 January 1972

1. By reference (a), the Department of Defense established a Contractor Cost Data Reporting system to collect projected and actual cost data from contractors for DOD cost analysis and procurement management purposes. Under the requirements of the system, raw cost data from NAVSHIPS contractors will be provided directly to the Office of the Secretary of Defense Cost Analysis Improvement Group. Reference (b) requests 08 comments on the draft instructions (references (c) and (d)) which will implement this cost data reporting system within the Department of the Navy and the Naval Material Command, respectively. The purpose of this memorandum is to provide my comments and to ask for your assistance in exempting nuclear shipbuilding from the requirements of reference (a).

2. I have previously expressed my concern over the establishment of independent ship cost estimating groups outside NAVSHIPS. Enclosure (1) sets forth my views and points out several examples where NAVSHIPS has had problems when unqualified people or organizations have made estimates, evaluations, or studies based on raw cost data taken out of context. This is so because ship cost estimators above the NAVSHIPS working level just do not have the intimate knowledge of current factors affecting shipbuilding that would enable them to use raw cost data effectively. As a result, NAVSHIPS personnel are required to expend much time and effort correcting erroneous data, assumptions and conclusions.

3. In my opinion, the Contractor Cost Data Reporting system will compound the problem of involvement by outside organizations in areas that are primarily NAVSHIPS responsibility. The reports generated by the requirements of reference (a)

are to be provided to NAVMAT, and to OPNAV and DOD systems analysts by NAVSHIPS. In addition, other DOD components may receive the reports upon request to the Department of the Navy and federal agencies outside the DOD may receive the reports upon request to the OSD Cost Analysis Improvement Group. Such unlimited distribution of raw data will result in NAVSHIPS personnel spending an increasingly greater amount of time interpreting this data and answering questions from higher echelons within the DOD rather than doing their own jobs.

4. If the Office of the Secretary of Defense considers that the NAVSHIPS cost estimating capability should be improved, the solution should be to require improvement in the cost estimating function within NAVSHIPS since NAVSHIPS is ultimately responsible for the accuracy of ship cost estimates. NAVSHIPS cost estimating capability cannot be improved by creating additional, independent cost estimating groups or by imposing external cost reporting requirements upon NAVSHIPS' contractors. Moreover, NAVSHIPS, not OSD, should be deciding the cost reporting requirements to be imposed on our contractors since NAVSHIPS must be responsible for ensuring it has adequate data to accurately estimate the cost of building ships.

5. Today it is harder than it has ever been to design and build Navy ships within appropriated funds. I predict it will become even harder if NAVSHIPS is required to implement and support a system for disseminating raw cost data that cannot be properly evaluated except by those directly responsible for building ships. I therefore recommend that NAVSHIPS arrange to exempt nuclear shipbuilding from the requirements of this system.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Material

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

19 JUN 1975

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS)

Subj: Request for assistance in obtaining supplier acceptance of urgent defense orders containing cost accounting standards requirements

Ref: (a) COMNAVSEA ltr Ser 607 dtd 17 Jun 75, subj: Vendor Acceptance of Purchase Orders; request for special priorities assistance

1. In reference (a), the Commander, Naval Sea Systems Command submitted, via the Chief of Naval Material, a formal request for Department of Commerce assistance under the Defense Production Act in requiring U.S. Steel, Ingersoll-Rand and Ladish to accept subcontracts from Electric Boat Division, General Dynamics Corporation. All three suppliers are currently refusing to accept orders for critical components needed for construction of nuclear-powered submarines and surface ships on the basis that they are unwilling to comply with cost accounting standards requirements.

2. Although I am somewhat familiar with the three cases involved, the Ladish case specifically involves work under my technical cognizance. The Ladish order involves TRIDENT submarine reactor plant forgings which pace reactor compartment construction schedules. At present Ladish is working on these forgings without a contract but has threatened to stop work if the Navy does not obtain a waiver of cost accounting standards. Ladish has accepted cost accounting standards in previous contracts.

3. I agree with the Commander, Naval Sea Systems Command that there is no valid basis to exclude Ladish or the other two suppliers from cost accounting standards. If the Navy supports a waiver request in these cases other contractors will undoubtedly adopt similar tactics. This would inevitably delay other projects and undermine the implementation of cost accounting standards. In addition, it would be unfair to excuse these contractors from cost accounting standards requirements when the vast majority of defense contractors are required to accept them.

4. I understand that the Naval Material Command has referred this matter to you. Apparently questions have been raised about whether the Navy should request the Department of Commerce to

require acceptance and performance of these orders under the Defense Production Act as recommended by the Commander, Naval Sea Systems Command or seek a waiver from the Cost Accounting Standards Board as proposed by the contractors.

5. Congress has legislated that defense contracts must include various requirements of which cost accounting standards is one. The Navy would be placed in an intolerable position if contractors could evade such requirements by threatening to hold up work on critical defense contracts. How the Navy handles these cases will set a pattern for the future. The Navy therefore should take strong action to insist on performance of the work in accordance with all applicable laws and regulations.

6. I recommend that you proceed in the manner recommended by the Commander, Naval Sea Systems Command. To preclude delays and increased costs to the Navy's shipbuilding program, prompt Navy action is required.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

10 JUL 1975

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY
(INSTALLATIONS AND LOGISTICS)

Subj: Request for Assistance in Obtaining Supplier Acceptance of Urgent Defense Orders Containing Cost Accounting Standards Requirements

Ref: (a) NAVSEA 08 Memo for the Assistant Secretary of the Navy (Installations and Logistics) of 19 June 1975

1. In reference (a), I stated that I agreed with the Commander, Naval Sea Systems Command's request for Department of Commerce assistance under the Defense Production Act in requiring U. S. Steel, Ingersoll-Rand, and Ladish to accept contracts containing Cost Accounting Standards requirements. I pointed out that if the Navy supports the contractors' requests to waive Cost Accounting Standards this would cause other contractors to request similar waivers. This situation would, in turn, delay procurement and undermine the implementation of Cost Accounting Standards. As I stated in reference (a), this matter has been referred to you because of the apparent question about whether the Navy should request the Department of Commerce to require acceptance and performance of these orders under the Defense Production Act as recommended by the Commander, Naval Sea Systems Command.

2. The situation with regard to the Ladish purchase order from Electric Boat for TRIDENT reactor plant forgings under my technical cognizance is becoming increasingly critical. Ladish has received the material for the forgings; however, forging of the material has not commenced as scheduled. Delivery of forgings to Electric Boat in August 1975 is necessary to support the reactor plant construction schedule for the lead TRIDENT submarine. Normally about four months would be required by Ladish to make the forgings, thus prompt action is required to maintain schedules and avoid a potential claim.

3. I understand that you advised Ladish of the urgent need for these forgings and requested that Ladish notify you by 7 July of their willingness to accept defense orders subject to Cost Accounting Standards. In the absence of

a prompt, favorable response from Ladish, I urge that you request the assistance of the Department of Commerce as recommended by the Commander, Naval Sea Systems Command. I would appreciate being advised of what action you take in this regard.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

17 August 1976

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Shipbuilding Priorities

1. By letter of 12 February 1973, the Chairman of the Board of Tenneco stated that "Tenneco will not allow performance of work on non-Navy contracts to interfere with the performance of work necessary to meet Newport News commitments on Navy contracts." He also stated "When either Newport News or the Navy has reason to question Newport News' ability to meet commitments on Navy contracts, Newport News prior to transferring personnel from Navy work to non-Navy work will make every effort to work out with the Navy a mutually satisfactory course of action to enable Newport News to meet commitments on Navy contracts."

2. Under date of 20 February 1976 the Commander, Naval Sea Systems Command signed a memorandum for the Deputy Assistant Secretary of Defense (Installations & Logistics) in which he requested that the office of the Secretary of Defense and/or the Commerce Department concur that the CVN 70 and the CGN 41 have precedence for priority purposes over the three LNG ships currently under construction at Newport News Shipbuilding and Dry Dock Company. It is my understanding that both you and the Chief of Naval Operations concurred in that memorandum and that after nearly four months it was forwarded on or about 10 June 1976 to the Assistant Secretary of the Navy (Installations & Logistics) for endorsement to the Deputy Assistant Secretary of Defense (Installations & Logistics). I am not aware of any action as yet having been taken on this memorandum.

3. In my memorandum to you of 2 June 1976 in which I commented to you on a letter to you from the President of Newport News Shipbuilding and Dry Dock Company dated 21 May 1976, I attached a report from the Supervisor of Shipbuilding, Newport News, which indicates that scarce Newport News manpower is being diverted to commercial construction work to the detriment of Navy work. I recommended that you take action to obtain priority assistance from the Department of Commerce to ensure that Newport News does not allow Navy work to be delayed by commercial work. I am not aware of any action as yet having been taken on this memorandum either.

4. Newport News is contractually obligated to deliver the CVN 70 by September 1980. In recent correspondence Newport News has indicated they intend to delay delivery of the CVN 70 about one year. The most recent reports from the Supervisor of Shipbuilding indicate that Newport News has decreased the production manning on the CVN 70, while increasing the production manning on commercial work.

5. I again recommend that you take action to obtain priority assistance from the Department of Commerce to ensure that Newport News does not allow Navy work to be delayed by commercial work and that you take action with Tenneco to require them to comply with the Tenneco policy in this regard committed by their Chairman of the Board.

6. Lack of action in this matter by the Navy is causing delay in construction and increased cost of the CVN 70.

H. G. Rickover

Copy to:
Secretary of the Navy
Chief of Naval Operations
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

1 [illegible]

Mr. John P. Diesel
President and Chief Executive Officer
Newport News Shipbuilding and Dry Dock Company
Newport News, Virginia 23607

Encl: (1) Newport News ltr dtd 25 July 1969
(2) NAVSEA ltr Ser 08M-1103 dtd 15 July 1969

Dear Sir:

By letter of 25 July 1969, enclosure (1), the President and Chief Executive Officer of Newport News agreed that Newport News would handle correspondence on matters under the technical cognizance of NAVSEA 08 in accordance with the procedures set forth in enclosure (2). The purpose of the agreement was to ensure that there would be no future misunderstandings concerning the contractual status of technical correspondence and other technical documents exchanged between shipbuilders and the Government or its design agents concerning matters under the technical cognizance of NAVSEA 08. Under the agreed procedures Newport News technical submittals since 1969 have either: (1) identified that the recommended action did not require changes in any contracts; or, (2) identified contractual changes considered necessary for implementing the recommended action so that NAVSEA could consider this information in making its technical decisions.

By following the procedure set forth in the agreement, Newport News has identified prior to work authorization whether the company considered the work to require a change in applicable contracts. This allowed contract changes to be priced out and issued prior to authorization of the changed work in cases where Newport News considered a contract change was required. The procedure also facilitates prompt action on technical correspondence.

As you are aware, it has been longstanding Department of Defense policy to price out changes in advance of performance. Newport News and other shipbuilders have testified that they also want to settle changes on a pay-as-you-go basis. The procedure set forth in the 1969 agreement facilitates this policy as it identified changes before they are performed. This early identification can avoid situations wherein a contractor performs additional work which is a change to his contract and then must attempt to get paid after the work is done.

Despite the foregoing, Newport News personnel have informally stated to NAVSEA 08 personnel that the company will no longer identify the contractual impact of actions recommended in the company's technical submittals. Newport News technical correspondence is now being received without the agreed contractual impact statements. Such action is in direct contradiction to the 1969 agreement. Moreover, this action could delay the processing of the large volume of technical correspondence essential to ship construction; e.g. approvals required by contract, inquiries to lead design yards, requests for specification waivers, and so on. It will also serve to frustrate our mutual objective of pricing out contract changes prior to the performance of changed work and will introduce delays in ship construction.

Based on the above I would appreciate your assurance that you will continue to honor the 1969 agreement and that you advise your personnel accordingly.

H. G. Rickover
H. G. Rickover

Copy to:
Deputy Secretary of Defense
Secretary of the Navy
Assistant Secretary of the Navy
 (Installations and Logistics)
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Supervisor of Shipbuilding, Newport News

NEWPORT NEWS SHIPBUILDING
AND DRY DOCK COMPANY *A Major Component of Tenneco Inc.* TENNECO
NEWPORT NEWS, VIRGINIA 23607 • PHONE 703-247-1211

July 25, 1969

VADM H. G. Rickover, USN
NAVSHIPS 08
Naval Ship Systems Command Headquarters
Washington, D. C. 20360

VIA

Supervisor of Shipbuilding
Conversion and Repair, USN
Newport News Shipbuilding and Dry Dock Company
Newport News, Virginia 23607

Subject: Technical Correspondence and Documents Exchanged Between Shipbuilders and the Government Regarding Work Under the Technical Cognizance of NAVSHIPS (08) in Ships Under Construction; Contractual status of

References:
(a) Ser 08M-1103 dated July 15, 1969
(b) Cen/4330, Ser 400-204 dated July 22, 1969

Dear Sir:

Effective August 1, 1969 the actions requested by reference (a), which was forwarded by reference (b), will be placed into effect.

With regard to paragraph 3.a(2) of reference (a), we will make every effort to meet the twenty day requirement; however, there may be cases such as receipt of large quantities of drawings, technical manuals, etc. in early stages of contracts or long complicated technical changes requiring comments from several of our divisions where we will need up to forty-five days to provide notification of a change.

Yours very truly,

L C Ackerman

L. C. Ackerman
President and Chief Executive Officer

Distribution on Page 2

Distribution

2 - NAVSHIPS 08 VIA SupShip, NN
1 - VADM H. G. Rickover, NAVSHIPS 08
1 - Mr. T. J. Walters, PNRO(NN)
1 - Mr. L. C. Ackerman
1 - Mr. C. E. Dart
1 - Mr. R. Broad
1 - Mr. D. E. Kane, Jr.
1 - Mr. J. H. Redpath, III

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
08M-1103
15 JUL 1969

From: Commander, Naval Ship Systems Command
To: Distribution

Subj: Technical Correspondence and Documents Exchanged Between Shipbuilders and the Government Regarding Work Under the Technical Cognizance of NAVSHIPS (08) in Ships Under Construction; Contractual status of

1. NAVSHIPS shipbuilding and design contracts provide for a considerable day-to-day interchange of technical correspondence between shipyards and the government or its design agents concerning matters under the technical cognizance of NAVSHIPS (08). For example:

a. Shipbuilders frequently submit proposed plan, technical manual, procedure and specification changes, and other technical correspondence to NAVSHIPS (08) and other government activities, reactor plant prime contractors, or the lead reactor plant design yard for action.

b. Lead reactor plant design yards submit many plans, documents, and other technical correspondence to NAVSHIPS (08) and other government activities for action.

c. Shipbuilding contracts specify that working plans, technical manuals, test procedures, and other design data for construction and testing of the reactor plants in nuclear powered ships will be furnished to the shipbuilder and are to be used without deviation. Reactor plant prime contractors, lead reactor plant design yards, and other activities furnish such design data, technical documents, and revisions thereto directly to shipbuilders.

2. Design data and technical documents furnished to the shipbuilder and technical replies to shipyard correspondence relating thereto are not intended to authorize contract changes and are not intended to require a contractor to take action not already within the scope of his contract. In some cases, shipbuilders have considered such technical correspondence as authorizing contract changes. For this reason NAVSHIPS considers that additional steps are necessary to ensure that there are no future misunderstandings concerning the contractual status of technical correspondence and other technical documents exchanged between shipbuilders and the Government or its design agents concerning matters under the technical cognizance of NAVSHIPS (08).

3. The following action is requested:

a. Shipbuilders

(1) Technical Correspondence to Government Activities, Reactor Plant Prime Contractors, or Lead Reactor Plant Design Yards - Shipbuilders are requested to include the following statement in all such correspondence concerning matters under the technical cognizance of NAVSHIPS (08):

> "The work that would result from approval of this submittal is within the scope of contract (s) (Insert appropriate contract numbers), and no change in the contract delivery or completion date or the current negotiated price or amount of any government contract with (Insert name of shipbuilder) is required."

If the above statement cannot be included in the submittal, the correspondence should be addressed to NAVSHIPS(08) via the cognizant Supervisor of Shipbuilding, citing the circumstances involved, the shipbuilder's estimate of the additional costs involved, the effect on ship delivery, and any alternate contractual arrangements considered necessary.

The above requirement does not apply to repairs or modifications to government-furnished reactor plant equipment. Repairs or modifications to government-furnished reactor plant equipment should continue to be handled in accordance with existing instructions.

(2) Reactor Plant Design Data and Technical Documents Furnished to Shipbuilders - Design data, technical documents, and revisions thereto furnished to shipbuilders by reactor plant prime contractors, lead reactor plant design yards, and other activities are issued on the basis that no change in the current negotiated price or amount, or contract delivery or completion date of any contract is involved. If the shipbuilder considers that the use of any such design data, technical documents, or revisions thereto requires a contract change, he shall not proceed with work affected by such design data or technical documents, but should promptly, and in any event within 20 days of receipt of such design data or technical documents, notify NAVSHIPS(08) in writing via the Supervisor of Shipbuilding of the facts and his reasons for considering that a contract change is required. However, in emergencies where:

(a) the circumstances do not allow sufficient time to notify NAVSHIPS (08) of the facts prior to the need to proceed with the work; and,

(b) the work must proceed to avoid hazards to personnel or facilities or to avoid additional cost to the Government,

the shipbuilder may proceed with work in accordance with the design data or technical document furnished. In such cases, the shipbuilder should notify NAVSHIPS(08) via the Supervisor of Shipbuilding as soon as possible, and in any event within 7 days, of his reasons for considering that a contract change is needed and the nature of the emergency which required his proceeding prior to notification of NAVSHIPS (08).

b. Lead Reactor Plant Design Yards

(1) Lead reactor plant design yards are requested to include the statement in paragraph 3.a.(1) above in future technical correspondence to NAVSHIPS (08) or other government activities. The statement should apply to both design work under design contracts and construction work under applicable shipbuilding contracts held by the shipyard. Where design or construction work proposed is not considered within the scope of applicable contracts, the correspondence should identify the estimated cost to perform the design or construction work involved, the effect on ship delivery, and any contractual arrangements considered necessary. In such cases, the shipbuilder is not authorized to perform design or construction work that is considered to be outside the scope of the contract until appropriate contractual arrangements are made.

4. The actions requested by this letter should be placed into effect expeditiously. Shipbuilders and lead reactor plant design yards are requested to confirm by 31 July 1959 that the actions requested by this letter are in effect.

5. The action requested by this letter is considered by NAVSHIPS to be within the scope of existing contracts, and no change in contract delivery or completion dates or in the current negotiated price or amount of any government contract is authorized.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Distribution:
Electric Boat Div., General Dynamics Corp.,
Groton, Via: SUPSHIP, Groton
Ingalls Shipbuilding Corp., Pascagoula
Via: SUPSHIP, Pascagoula
Newport News Shipbuilding and Dry Dock Co.,
Newport News, Via: SUPSHIP, Newport News
Electric Boat Div., General Dynamics Corp.,
Quincy, Via: SUPSHIP, Quincy

Copy to:
PNRO Rep., Groton (2)
PNRO Rep., Pascagoula
PNRO Rep., Newport News
Gen. Mgr., Bettis
Gen. Mgr., KAPL
Gen. Mgr., NAO
Gen. Mgr., PAD

DEPARTMENT OF THE NAVY
NAVAL SHIP SYSTEMS COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
Ser 08N-2211

20 Dec 1971

From: Commander, Naval Ship Systems Command
To : DISTRIBUTION

Subj: Technical Documents and Design Data Furnished to Shipbuilders by Reactor Plant Prime Contracts and Reactor Plant Lead Yards for Ships Under Construction, Request to Specify Contractual Impact

Ref : (a) NAVSHIPS letter Ser 08M-1103 dated 15 July 1969(NOTAL)

1. Reference (a) provides that design data furnished to shipbuilders by lead reactor plant design yards and reactor plant prime contractors for ships under construction are issued on the basis that no contract change is required. Reference (a) prescribes the procedure to follow and the notification to be made wherever the shipbuilder considers that such information requires a contract change. All nuclear qualified shipyards have acknowledged their acceptance of these arrangements.

2. Recently NAVSHIPS discovered that one shipbuilder was accepting technical information from a design agent on the basis that it might result in a contract change at some later time. Proper notification, as required by reference (a), was not provided. To avoid recurring problems in this area, reactor plant prime contractors and lead reactor plant design yards should include the following disclaimer in all future correspondence transmitting technical documents and design data in areas under the technical cognizance of NAVSHIPS (08) to shipbuilders for ships under construction.

> (Insert name or originator) does not have the authority to modify contracts between the shipbuilder and the government. Therefore if the action contained herein is considered by the shipbuilder to require a change in the currently negotiated price or amount or delivery or completion date of any contract, the shipbuilder shall not proceed with the action contained herein but should promptly, and in any event within 20 days of receipt of this document, notify NAVSHIPS (08) via the Supervisor of Shipbuilding of the facts and the reasons for considering that a contract change is required.

3. The action requested by this letter should be placed into effect upon receipt of this letter. Lead reactor plant design yards and reactor plant prime contractors are requested to confirm by 15 January 1972 that the actions requested by this letter are in effect.

4. The action requested by this letter is considered by NAVSHIPS to be within the scope of existing contracts, and no change in contract delivery or completion dates or in the current negotiated price or amount of any government contract is authorized.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

DISTRIBUTION:
Electric Boat Division, General Dynamics Corporation,
Groton, Via: SUPSHIP, Groton
Newport News Shipbuilding and Dry Dock Co.,
Newport News, Via: SUPSHIP, Newport News
Electric Boat Division, General Dynamics Corp.,
Quincy, Via: SUPSHIP, Quincy
PNRO
SNRO
ANSTR, MAO
ANSTR, PAD

Copy to:
PNRO Rep., Groton (2)
PNRO Rep., Pascagoula
PNRO Rep., Newport News
General Manager, Bettis
General Manager, KAPL
General Manager, MAO
General Manager, PAD
Ingalls Shipbuilding Corp., Pascagoula
Via: SUPSHIP, Pascagoula

NEWPORT NEWS SHIPBUILDING,
Newport News, Va., November 29, 1976.

Admiral H. G. RICKOVER,
Deputy Commander for Nuclear Propulsion, Navy Sea Systems Command, Department of the Navy, Washington, D.C.

DEAR SIR: This is in response to your letter of November 10, 1976, wherein you requested that the company "honor" a purported agreement concerning the handling of correspondence on matters under the technical cognizance of your office. You state that this purported agreement was intended to ensure that there would be no future misunderstanding concerning "the contractual status of technical correspondence and other technical documents." Let me assure you that there is no misunderstanding on the company's part as to the "contractual status" of such documents. They have no contractual status.

In previous years, the company, at the demand of NAVSEA 08 representatives, has included statements in technical correspondence that such correspondence did not require a change to the contract. Such correspondence was issued by company employees who, as the Navy was aware, were not authorised to bind this company contractually. When it became apparent that the Navy was taking a position that such statements barred future equitable adjustments when a Navy action did in fact involve a contract change, the company had no choice but to order its employees to stop using the language in correspondence with the Navy.

As you are well aware, there are many instances where a company employee who initiates an item of technical correspondence has no way of knowing whether or not it requires a change to the contract at that time. Indeed, in many cases the Navy is in a better position than the company to know whether a change is involved or whether costs will be affected. To halt performance pending an analysis and determination as to the contractual effect of the resolution of a technical problem would significantly delay contract performance. We do not believe that such delay and the additional cost associated therewith is either required by our contracts or desired by the Navy.

Your attempt to justify a requirement for such language on the basis that it facilitates pricing out of changes is a transparent effort to obscure the true reason for your insistence on such language. It is now apparent to the company that you have insisted upon the use of such language for the purpose of attempting to shift to the company the cost and schedule risk of changes for which the Navy is constractually responsible.

Accordingly, please be advised that the company categorically denies that technical correspondence has "contractual significance." Further, so long as the Navy continues to assert that such correspondence has contractual significance in that inclusion of the Navy's requested language will preclude subsequent equitable adjustments, the company declines to include such language in its correspondence. Further, to the extent there are delays in construction due to failure of the Navy to respond or act upon the company's technical correspondence, the company will hold the Navy responsible for all cost and schedule impact or otherwise assert its legal rights.

We also request that, in the future, all contractual matters should be addressed to the company by the cognizant Contracting Officer.

Sincerely yours,

J. P. DIESEL,
President.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
12 Jan 1978

MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE

Subj: Shipbuilding claims

Encl: (1) Comparison of Newport News and Electric Boat Costs to Construct SSN688 Class Submarines (NOTE: THIS ENCLOSURE CONTAINS INFORMATION WHICH MAY BE PROPRIETARY)

1. During your meeting last Friday with the Secretary of the Navy and me, I promised to send you information regarding the efficiency of Electric Boat relative to Newport News. Enclosure (1) is a comparison of incurred and projected manhours and costs reported by these shipbuilders for construction of SSN688 Class submarines. Both yards are building identical ships, to the same drawings, during roughly the same time frame. Yet, for the first four ships at each yard, the labor hours incurred or projected by Electric Boat are about 15 percent higher than the labor hours reported by Newport News. The estimated total cost at completion of the first four ships at Electric Boat is about 40 percent higher than at Newport News. Electric Boat's proposed price for the forthcoming overhaul of the USS SPADEFISH (SSN668) was nearly 50 percent higher than that proposed by Newport News. It should be recognized that declining productivity has been a problem at Electric Boat for several years.

2. In assessing the shipbuilding cost overruns in the SSN688 Class submarine construction program, it should be borne in mind that:

- The contract for the ship design was awarded to Newport News on a sole-source, cost-plus basis.

- A fixed-price-incentive-fee contract to construct the lead ship of the class, the SSN688 in the FY 1970 program, was negotiated with Newport News on a sole-source basis.

- Competitive bids for the first eleven follow ships, SSN's 689-699, appropriated in the FY 1970-1972 programs, were submitted by Ingalls, Electric Boat, and Newport News in 1970.

- All three bidders had extensive nuclear submarine building experience. At the time of bidding:

  Ingalls had delivered nine nuclear attack submarines and was building three more.

  Newport News had delivered 21 nuclear attack and missile submarines.

  Electric Boat had delivered 32 nuclear attack and missile submarines of many classes and was building six more nuclear attack submarines. Electric Boat has been the Navy's principal nuclear submarine designer starting with the NAUTILUS.

- Since three qualified, experienced nuclear submarine builders submitted responsive competitive bids for these eleven submarines, the pricing proposed by the bidders was accepted without negotiation.

- Based on the bids, the lowest total contract price for the first eleven follow ships resulted from awarding seven to Electric Boat, four to Newport News, and none to Ingalls.

3. Upon reflecting on last Friday's meeting, I realized that the notes I left with you and Secretary Claytor regarding shipbuilding claims did not adequately address some aspects of the problem. This memorandum comments further on those points.

4. One of my recommendations was that before deciding to grant extra-contractual relief to a company that states it is in financial difficulty, the Government should verify the company's true financial condition through the Securities and Exchange Commission (SEC). Secretary Claytor suggested that it might be better to have the Defense Contract Audit Agency (DCAA) perform this task since that agency is experienced in defense contracting.

5. Although DCAA can be of assistance and should be consulted, it does not have the legal authority to review contractor records pertaining to non-defense business. A DCAA audit of a corporation's overall financial condition can be thwarted if corporate officials refuse to grant unrestricted access to their records. The SEC, however, has access to corporate records and is therefore in the position to assess the overall financial condition of a company. For this reason I believe

it essential that the SEC as well as DCAA verify the financial figures presented by shipbuilders before the Defense Department decides to provide extra-contractual relief.

6. The matter of litigative risk also deserves further discussion. I left the meeting with the impression that Secretary Claytor and Assistant Secretary Hidalgo were considering assigning litigative risk factors to Navy claim settlement offers based on their own business and legal experience. I believe it would be far better to rely on the Navy Claims Settlement Board for that function.

7. At present, the Board assesses litigative risk and includes amounts for this purpose in its settlement offers. I understand that the Board's attorneys base these estimates of litigative risk on their detailed review of each claim item; the results of the Government's technical analysis; evaluation of applicable case law; and, presumably, consideration of possible violations of fraud or false claims statutes. I doubt that the Navy Secretariat will have the necessary time to review all this material, and develop and document an independent assessment of litigative risk.

8. Moreover, under the terms of Navy contracts the Secretary of the Navy is the official to whom a shipbuilder appeals Contracting Officer decisions. The Secretary has delegated his authority to act on such appeals to the Armed Services Board of Contract Appeals (ASBCA), which handles contract appeals for all the military services. If the Secretariat participates in establishing Navy claims settlement offers and the disputes are subsequently appealed to the ASBCA, the question could arise: How can the ASBCA, acting for the Secretary of the Navy, fairly resolve a contractor's appeal from a decision in which the Secretary himself participated? This, therefore, is another reason the Navy would be in a far better position if the Secretariat would rely upon the Navy Claims Settlement Board, rather than trying to apply its own factors for litigative risk.

9. In any event, litigative risk should be dealt with carefully. Basically, it consists of a judgment of the likelihood that the Government might receive an unfavorable ruling by the ASBCA or a court on items for which the Government does not believe it is liable. If, on a $100 million claim item, a Government official considers there is a 25 percent chance of losing, he might include $25 million in the settlement offer. If he concludes the odds are 50/50, he might include $50 million in the claim settlement offer. The Government official assessing litigative risk becomes, in

effect, a judge. He tries the case in his mind as if he were the ASBCA or a court. His estimates can add hundreds of millions of dollars to the Government's claim settlement offers. If his estimates are excessive, there is no formal avenue of Government appeal. For this reason, strict control and careful review of assessments of litigative risk are essential.

10. It is also important to ensure that claim settlements based on litigative risk do not compromise contract principles applicable to other contracts or to future work. Specifically, large portions of both the Newport News and Electric Boat claims challenge the validity of certain contract provisions and procedures which have been in effect for many years and remain in effect today. To maintain a viable basis for conducting future Defense Department business the underlying disputes must be resolved--even if they must be litigated. In the absence of such a resolution of the issues, an expedient claim settlement based on litigative risk would leave the Navy and the shipbuilder at an impasse concerning these same issues in their day-to-day work, and would invite future claims.

11. As I pointed out during our meeting and in my testimony of 29 December 1977 to the Joint Economic Committee, the Navy must put a stop to the submission of false and inflated claims. They waste our time and money and threaten the integrity of all Government contracts. The only effective deterrent I know is to enforce the Federal statutes pertaining to fraud and false claims.

12. Some have questioned whether what we are finding in the shipbuilding claims actually constitutes fraud. The description of fraud in two standard legal texts is quite broad. Here are excerpts which I believe are apropos:

> "Black's Law Dictionary
>
> Revised Fourth Edition 1968
>
> Fraud
>
> An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right; a false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act

upon it to his legal injury...Any kind of artifice employed by one person to deceive another...A generic term, embracing all nefarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestion or by suppression of truth, and includes all enterprise, trick, cunning, dissembling, and any unfair way by which another is cheated."

"American Jurisprudence

Second Edition
Volume 37 1968

Fraud and Deceit

"...it has been said that there can be no all-encompassing definition of 'fraud' but each case must be considered upon its own particular facts. The term 'fraud' is a generic one which is used in various senses, and fraud assumes so many different degrees and forms that courts are compelled to content themselves with comparatively few general rules for its discovery and defeat, and allow the facts and circumstances peculiar to each case to bear heavily on the conscience and judgment of the court or jury in determining its presence or absence. In fact, the fertility of man's invention in devising new schemes of fraud is so great that courts have always declined to define it, reserving to themselves the liberty to deal with it in whatever form it may present itself. It is, indeed, said that it is better not to define the term lest the craft of men should find ways of committing fraud which might evade such a definition."

"Nevertheless, while it has often been said that fraud cannot or should not be precisely defined, the books contain many definitions such as unfair dealing, malfeasance, a positive act resulting from a wilful intent to deceive; an artifice by which a person is deceived to his hurt; a wilful, malevolent act, directed to perpetrating a wrong to the rights of others; anything which is calculated to deceive, whether it is a single act or a combination of circumstances, or acts or words which amount to a suppression of the truth, or mere silence; deceitful practices in depriving or endeavoring to deprive another of his known right by means of some artful device or plan contrary to the plain rules of common honesty; the unlawful appropriation of another's property by design; and making one state of things appear to a person with whom dealings are had to be the true state of things, while acting on the knowledge of a different state of things. Fraud

> has also been said to consist of conduct that operates prejudicially on the rights of others and is so intended; a deceitful design to deprive another of some profit or advantage; or deception practiced to induce another to part with property or to surrender some legal right, which accomplishes the end desired. Fraud therefore, in its general sense, is deemed to comprise anything calculated to deceive, including all acts, omissions, and concealments involving a breach of legal or equitable duty, trust, or confidence justly reposed, resulting in damage to another, or by which an undue and unconscientious advantage is taken of another."

13. The above descriptions of fraud seem to fit the shipbuilding claims situation exactly. Specifically, the reports I have submitted to date are examples of the following:

- Statements which are demonstrably untrue.
- Statements apparently designed to mislead.
- Withholding of documents which would disprove allegations of Government responsibility.
- Alleged Government responsibility for costs which are the shipbuilder's responsibility under the contract.
- Claims for costs that have already been reimbursed.
- Claims for costs which have not or will not be incurred.

14. Because of the many reports of possible fraud submitted by others as well as myself in connection with these claims, it is obvious that, sooner or later, these reports will have to be sent to the Department of Justice. That Department has the legal authority and capability to conduct fraud investigations and decide whether or not to pursue an indictment; the Defense Department does not. Lengthy review by the Navy Office of General Counsel prior to forwarding these reports to the Department of Justice only delays an investigation and could jeopardize it. Further, delay by the Navy could create the impression that the Navy is deliberately dragging its feet and trying to avoid an investigation.

15. I know that both you and Secretary Claytor desire to get ships for the Navy and to resolve quickly what has been for several years a serious and festering problem. However,

one of the reasons so little progress has been made is that in the past some well-meaning officials have, by their words and actions, encouraged shipbuilders to believe they will not have to honor their contracts, and that eventually the Government will take care of their financial problems.

16. As I have pointed out, simply paying off the shipbuilders would not solve the problem. The Navy and the Defense Department would find themselves in similar circumstances the next time these same shipbuilders run into financial problems. Also, other defense contractors could be expected to follow the example set by the shipbuilders. Thus, it is of utmost importance that any actions taken to resolve the shipbuilding claims problem are carried out in a manner which does not undermine long and well-established principles of Government contracting.

Very respectfully,

H. G. Rickover
H. G. Rickover

Copy to:
Secretary of the Navy

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
5 Apr 1978

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Procurement of Fiscal Year 1978/1979 SSN 688 Class submarines

Ref: (a) SSN 688 Class AdvancedProcurement Plan No. 143-78
(b) Draft forwarding letter Ser 321 requesting SSN 688 Class proposals from Electric Boat and Newport News

1. I understand that on 30 March 1978, the Secretary of the Navy disapproved the NAVSEA plan to procure the FY 1978/1979 SSN 688 Class submarines on a sole source basis from Newport News. NAVSEA was instead directed to solicit competitive bids from both Electric Boat and Newport News. Consistent with this decision your staff is now circulating for concurrence an Advanced Procurement Plan, reference (a), which purports to justify soliciting proposals from Electric Boat as well as Newport News. I have also been asked to comment on a proposed forwarding letter which would be sent to Electric Boat and Newport News as part of the Request for Proposal. I understand that the Secretary has directed that reference (b) be cleared with Assistant Secretary Hidalgo prior to release.

2. In my view the Navy is making a mistake by inviting a bid from Electric Boat on the SSN 688 Class procurement. I have testified to Congress and recommended to senior defense officials that the Navy should not award any more contracts to Electric Boat for several years--until that shipyard works off a large part of its present backlog and can effectively demonstrate its ability to handle more work.

3. The Navy's recent exercise of the Trident contract option has added two more TRIDENT submarines to the existing backlog at Electric Boat. Awarding more SSN 688 Class submarines to Electric Boat would further compound Electric Boat's production problems. Moreover, it does not make sense to solicit bids from Electric Boat for construction of more SSN 688 Class submarines when the company is threatening to stop work on earlier contracts for ships in the same program.

4. It seems to me that instead of offering them more business the Navy should start dealing firmly with shipbuilders who stop work or threaten to do so. For example, if General Dynamics carries out its threat to stop work on its SSN 688 Class contracts, I would recommend that the Navy terminate for default three of the last SSN 688 Class submarines awarded to Electric Boat--ships upon which little or no work has been done on actual ship construction. These ships could then be packaged with the FY 1978/1979 procurement and offered on a sole source basis to Newport News on the condition that Newport News would accept the same terms and conditions it agreed to last September on its last SSN 688 Class submarine construction contract.

5. If Newport News is unwilling to accept additional SSN 688 Class submarines on the same terms that were previously negotiated and agreed to, then the Navy should take prompt steps to obtain an assured source of supply for SSN 688 Class submarines at the Mare Island Naval Shipyard. Funds for re-establishing Mare Island's submarine construction capability might be made available from those freed up by defaulting Electric Boat on its later ships.

6. In any event, I do not concur with the proposed advanced procurement plan. If Electric Boat is solicited for additional SSN 688 Class submarines and elects to submit a low bid, or if Newport News declines to bid, the Navy will find itself in an untenable position.

7. I recognize that the Secretary of the Navy has directed that the SSN 688 Class procurement be handled as set forth in reference (a). However, since you are required to obtain approval of references (a) and (b) from higher authorities, I request that you forward with that submittal a copy of this memorandum in connection with the Secretary of the Navy's possible reconsideration of his decision.

8. I would appreciate being advised of what action is taken on this matter.

H. G. Rickover

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
00:Cdb
5 Apr 1978

MEMORANDUM FOR DEPUTY COMMANDER FOR NUCLEAR PROPULSION (SEA 08)

Subj: Procurement of FY 1978/1979 SSN 688 Class Submarines

Ref: (a) Your memo dtd 5 Apr 1978 (same subject)

1. Reference (a) requested that I forward it with my request for approval of SSN 688 Class Advanced Procurement Plan No. 143-78.

2. Reference (a) will be so forwarded.

Very Respectfully,
C R Bryan
C. R. BRYAN
Commander, Naval Sea Systems Command

DEPARTMENT OF DEFENSE UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
8 Sep 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Shipbuilding claims

Ref:
(a) NAVSEA ltr Ser 08M-4742 dtd 7 Sep 1978
(b) My memo to you dtd 24 Aug 1978, subj: Shipbuilding claims
(c) Electric Boat ltr dtd 6 Sep 1978
(d) My memo to you dtd 14 Aug 1978, subj: Problems that need to be resolved in connection with the proposed PL 85-804 settlements
(e) My notes for discussion with you dtd 18 Aug 1978, subj: Shipbuilding claims

1. The purpose of this memorandum is to report that day-to-day contractual problems at Electric Boat are growing worse; that these problems are now encroaching upon the Navy's ability to have the company perform work which is technically necessary; and that, absent corrective action, the situation can only be expected to deteriorate further. This situation stems directly from Electric Boat policies which make it very difficult to administer Navy shipbuilding contracts properly and on a pay-as-you-go basis. Accordingly, I am again requesting that you quickly obtain General Dynamics written commitment to abandon these policies, before the proposed PL 85-804 settlements take effect.

2. An Electric Boat contract change proposal dated 29 August 1978, illustrates why action must be taken now to establish a proper basis for conducting Navy business with that company. The pertinent background is as follows:

a. Two Government-furnished gate valves on the SSN 698 were improperly operated by ships force.

b. The desired valve replacement work is the Government's contractual responsibility. The problem is that Electric Boat has inflated proposed costs to accomplish the actual replacement, by including additional costs for arbitrary or unsubstantiated factors, as explained below.

c. In its change proposal, the company contends that replacement of the two valves will delay the nuclear core installation by 10 days. For this effort, the company proposed a cost of $32,088 for 2,047 additional manhours--25 nuclear support personnel full time for the 10-day period. This proposed amount appears to be greatly inflated.

d. As I have explained in prior correspondence, Electric Boat has now begun to allege that performance of work on changes requires an acceleration of unchanged work to offset the "delaying effect" of the change. In order to recover from the effects of the change, Electric Boat states it will be forced to extend its workdays and accomplish unchanged contract work on an overtime basis. Electric Boat arbitrarily estimates that the amount of alleged overtime manhours is equivalent to the manhours added by the change. In the valve replacement proposal, Electric Boat included a cost of $21,619 for an overtime premium; this additional cost is 50 percent of the direct production labor cost proposed for the change.

e. In addition, the company states that overtime will reduce productivity, and that the resultant "loss of labor effectiveness" will constitute 25 percent of each overtime hour worked. This "loss of labor effectiveness" factor adds to the change proposal costs of $20,645 for 1,317 additional manhours.

3. In reference (a) I advised the Supervisor of Shipbuilding at Electric Boat that although it would be highly desirable to replace the valves at this time, the terms proposed by Electric Boat are unacceptable. This is the second time in recent weeks where work had to be deferred due to Electric Boat pricing policies. The first incident involved changed work on the SSN 698 reactor vessel test head. As I explained in reference (b), I asked the Supervisor of Shipbuilding to bring that item to the attention of Mr. Veliotis, the General Manager of Electric Boat, as an example where the company is frustrating the conduct of day-to-day business on shipbuilding contracts by trying to overcharge the Navy.

4. Reference (c) is Mr. Veliotis' response. Reference (c) states that the factors presently being used by Electric Boat to price acceleration and loss of labor effectiveness are "neither arbitrary nor unsubstantiated." Reference (c) describes the company's current approach as "taking a first step toward developing a workable formula or other approach which will produce equitable results..." The basic fallacy in this approach is Electric Boat's underlying assumption that every change delays shipyard work, no matter when the change is issued, what trades are involved, or what work is required.

5. It makes no sense for Electric Boat to represent that it has the capacity to take on new contracts while at the same time maintaining that every change tc the company's existing workload requires excessive amounts of overtime and "loss of labor effectiveness." As I stated in reference (d), the Navy does owe its contractors the legitimate costs of contract changes, including any associated delay, disruption, or acceleration costs. But the price of changes should not be padded by inclusion of arbitrary and unsubstantiated factors. Electric Boat's recent policy in this regard in effect serves notice to the Navy that every time a contract change is necessary, a premium must be paid to help the company recover past losses.

6. In reference (d) and during our meeting on 18 August 1978, I emphasized the need for you to obtain a written commitment from the Chairman of the Board of General Dynamics to stop inflating price proposals for changed work. I also explained to you Electric Boat's theory that even minor revisions to Government-furnished drawings and other technical data are "changes" which entitle the company to have its contracts repriced.

7. To put to rest, once and for all, the much publicized controversy over drawing revisions, I recommended in reference (d) that as part of the claims settlement you obtain General Dynamics agreement to contract language proposed by the Naval Sea Systems Command which spells out the rights and obligations of the parties in this area. Also, as explained in reference (e), I recommended that you obtain from the Chairman of the Board of General Dynamics, Mr. David Lewis, a written policy statement setting forth the principles under which the company will conduct future business with the Navy. This written policy statement should address, in a manner satisfactory to the Navy, the drawing revision issue; false and inflated claims; compliance with the so-called anti-claims clauses; as well as the issue of inflated pricing proposals described above. I do not know whether you have raised these issues with Mr. Lewis. However, it is evident that the problems persist.

8. Today, we in the Navy are, in essence, working for the contractor. The Navy policy is to administer contracts on a pay-as-you-go basis. Navy technical personnel are instructed, and properly so, to settle all aspects of a proposed contract change before authorizing it. Yet a contractor, so inclined, can frustrate this policy simply by inflating the prices he proposes for a change or by taking a contractual position he knows the Navy cannot accept. This is obviously Electric Boat's strategy: to leave the Navy with a "Hobson's Choice,"--either:

a. Meet the company's terms; or

b. Unilaterally direct the company to perform the change knowing that a claim will be submitted; or

c. Defer work that should be performed now and get it accomplished after ship delivery.

9. By its current practice, Electric Boat has effectively nullified the Navy's ability to administer its contracts. The traditional customer-seller relationship is being turned on its head. Services which the Navy has the right to expect from Electric Boat under the contract are no longer being rendered. The situation is analagous to a man having to accept an ill-fitting suit of clothes because his tailor insists on charging an outrageous price for moving a button.

10. In recent years shipbuilders have found that the Navy is rarely willing to "draw the line" on contract issues. Each Navy official, his superior or successor, gives away a little more in an effort to appease a shipbuilder. As a result, the Navy is constantly being ratcheted to the point that contracts have become meaningless; the Navy might as well give up the pretense of fixed priced contracting.

11. The time has come to draw the line with General Dynamics. No private citizen or head of a commercial firm would tolerate doing business with a company that treated him in this manner. Why should the Navy? Unless the situation is remedied, the PL 85-804 settlement arranged by you and Mr. Hidalgo will backfire, destroying the Navy's already fragile credibility, and rendering it incapable of administering fixed priced contracts in future.

12. The issues I have raised are not academic. Today the Supervisor of Shipbuilding at Electric Boat has almost 600 unadjudicated proposals for TRIDENT drawing revisions which Electric Boat contends are contract changes. Unless you are able to reach agreement with General Dynamics as to the rights and obligations of the parties in the matter of drawing revisions, those revisions will later resurface in an omnibus claim.

13. In my opinion, the recent contractual actions by Electric Boat speak louder than any oral assurances company officials may have given that the proposed PL 85-804 settlements will pave the way towards harmonious business relations with the Navy. It appears to me that in the coming months and years Electric Boat intends to generate claims on both the TRIDENT and SSN 688 Class contracts, and that these claims, together with the overpricing of contract changes, will become a basis for offsetting all or a portion of the $359 million loss the company has agreed to accept under the PL 85-804 settlement.

Also, it is important to remember that historically, Electric Boat claims have increased in parallel with increases in the company's projected end costs of SSN 688 Class construction. In this regard the Public Accounting firm of Coopers and Lybrand has concluded that Electric Boat's present estimated cost to complete the present SSN 688 Class construction workload is based on assumptions "which appear optimistic in light of recent experience on the SSN 688 contracts and the history of the Electric Boat Division." Based on past experience, this finding is ominous.

14. In summary, we cannot afford and should not tolerate the manner in which Electric Boat is currently conducting business with the Navy. We must face this issue squarely. If we do not, the problem will inevitably spread to other defense contracts.

15. In the past several months, I have repeatedly explained why I believe that the proposed PL 85-804 settlements leave the Navy vulnerable to future shipbuilding claims and why specific corrective action must be taken now to assure proper conduct of our business in future. I have also asked to be advised of progress in resolving these problems. I have never received a response. In the meantime the situation grows worse.

16. The matters I have raised directly and adversely affect my ability to execute my responsibilities. I must depend upon you--my superior--for assistance in getting General Dynamics to act responsibly in shipbuilding affairs. Therefore, I would appreciate being notified of the actions that will be taken in this regard.

H. G. Rickover

Copy to:
Under Secretary of the Navy
Assistant Secretary of the Navy
 (Manpower, Reserve Affairs and Logistics)
General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Chairman, Navy Claims Settlement Board
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

MEMORANDUM FOR THE SECRETARY OF THE NAVY

20 SEP 1978

Subj: Shipbuilding claims

Ref: (a) My 14 Aug 1978 memo to you
(b) EB ltr Ser 2222 dtd 7 Sep 1978
(c) EB ltr Ser 688/2736 dtd 11 Sep 1978

1. In recent correspondence I have pointed out examples showing that Electric Boat is actively laying the groundwork for future claims on TRIDENT and SSN 688 Class submarine construction contracts. My purpose in writing to you again is to provide you with additional information concerning contractual problems at Electric Boat.

2. One example of General Dynamics actions in laying the groundwork for future claims which I discussed in my memoranda to you, involved Electric Boat requesting a contract change to correct a TRIDENT shielding drawing. The correction added a requirement to drill a single 1½ inch hole in each ship. The revision was necessary to correct an error made by Electric Boat in its capacity as the Government's design agent under the TRIDENT design contracts.

3. As I explained in reference (a) and in our subsequent meeting on 18 August, shipbuilding contracts are neither priced, negotiated, nor intended to be administered on the basis that every drawing revision constitutes a contract change. The shield construction in the TRIDENT shipbuilding contract was priced on the basis of a manhours-per-pound estimate, not on the basis of the detailed drawings. Further, the TRIDENT contract provides a 45 percent margin between follow ship target cost and ceiling price to provide for uncertainty. As a result, I turned down the company's request for a contract change, and predicted a claim from Electric Boat would follow.

4. By reference (b) Electric Boat has now withdrawn the request for a contract change to add the 1½ inch hole. Apparently company officials have decided to "back off" on this example--but in a way that leaves the basic issue unresolved. Specifically, reference (b) states:

> "Upon further review of the facts, Electric Boat has concluded that, if the drawing error had not been made by the design agent and if the original drawing had embodied the most economical proper design for attaching annulus shield segments to the tank top, it would have included the counterbored hole added by the proposed drawing revision...".

* * * *

> "Although Electric Boat has withdrawn its notification, it is important to point out, in the interest of avoiding future misunderstanding, that such withdrawal was made for the reasons outlined above and that Electric Boat does not agree with the NAVSEA position as set forth in paragraph 4 of reference (b)."

5. The NAVSEA position to which Electric Boat refers is that revisions to drawings are an inherent feature of ship construction contracts; that the contractor agreed to build the ship to the drawings "including revisions thereof"; and that the contractor is not entitled to a contract change unless the revision changes the requirements of the ship specifications or requires ripout, rework, or changes to material on order.

6. As noted in reference (a), the Naval Sea Systems Command previously tried to settle this issue of drawing revisions in the contract modification implementing the PL 85-804 settlement. NAVSEA proposed contract language which would have formalized the criteria for entitlement to a contract change for a drawing revision. The company objected; apparently senior Navy officials agreed to delete the clause.

7. The drawing revision controversy at Electric Boat must be resolved. The Supervisor of Shipbuilding at Electric Boat currently has almost 600 requests for contract changes due to drawing revisions on the TRIDENT contract. No doubt there will be thousands of additional revisions to both TRIDENT and SSN 688 Class drawings in future.

8. The company is apparently trying to establish a basis for claims in other areas as well. For example, recently a Government-sponsored team consisting of representatives from the Government, the design yard, and a valve manufacturer was sent to Electric Boat to verify that required equipment field modifications had been made to hydraulic control valves in the SSN 696. In reference (c), however, Electric Boat stated that the Government-sponsored team could not have unescorted access to the ship and that the Government would have to issue a contract change to pay for an Electric Boat escort. The "Access to Vessels" clause of these contracts, however, states:

> "Officers, employees and associates of other prime contractors with the Government and their subcontractors, shall, as authorized by the Supervisor, have, at all reasonable times, admission to the plant, access to vessel(s) where and as required, and be permitted, within the plant and on the vessel(s) to perform and fulfill their respective obligations to the Government."

In this case, the Supervisor of Shipbuilding denied the company's request for a contract change and proceeded with the inspection. It would not surprise me, however, if the company later submits a claim.

9. Last night another incident arose which highlights what it is like trying to conduct business with Electric Boat in the current climate. The pertinent facts are as follows:

a. On Saturday, 16 September 1978, Electric Boat, in conducting the reactor plant test program on the BREMERTON (SSN 696), discovered a malfunction in a Government-furnished differential pressure detector installed in the port steam generator level indicating system.

b. Consistent with a longstanding procedure, the company reported the problem to the naval nuclear propulsion program prime contractor representative--the Knolls Atomic Power Laboratory representative (KAPL) and proceeded to troubleshoot the problem in order to ascertain what was wrong.

c. On Sunday, 17 September, Electric Boat received technical approval of its recommendation to replace the detector, and did so.

d. On Monday morning, 18 September, Electric Boat reported leakage in the new detector which, after shop hydrostatic testing by Electric Boat, had been installed in the plant. The company recommended removal of the second detector and reinstallation of the original unit which the company concluded had been fouled by dirt. Electric Boat requested funding for this work.

e. The KAPL representative approved the Electric Boat recommendation to reinstall the original unit, but stated that funding would not be provided because the presence of dirt in the reactor system--an Electric Boat responsibility--rather than defective Government-furnished equipment, appeared to be the cause of the failure.

f. On Monday evening, Electric Boat proceeded to reinstall the original detector and, at 2100, began testing it.

g. At about 0400 Tuesday, 9/19/78, Electric Boat stopped testing because the detector was still not working properly. At 0900, the company notified the KAPL representative of the latest problem and recommended replacing the detector with one in storage.

h. About 1040, 9/19/78, KAPL acknowledged that the original detector problem was not caused by dirt but by a defect in the detector. KAPL then requested Electric Boat to submit a proposal to replace the detector under a cost type task order contract by which KAPL normally pays for correction of defective Government-furnished equipment.

i. About 1115, Electric Boat informed KAPL that the company would not accept a KAPL work authorization but would require contractual authorization under the Navy's shipbuilding contract. At approximately 1500 on Tuesday, 9/19/78, Electric Boat reported the problem to the Supervisor of Shipbuilding and requested contractual authorization under the shipbuilding contract but did not submit a price proposal.

j. About 1700 on 9/19/78, NAVSEA 08 was informed that the Supervisor of Shipbuilding needed to obtain a contract change proposal or the Government would have to order the requested change on a unilateral, unpriced basis on the shipbuilding contract. At NAVSEA 08 request, the Supervisor requested Electric Boat to quote a maximum price for the requested change before authorizing it. The responsible Electric Boat representative would not provide such an estimate.

k. About 1800, I tried to contact the General Manager of Electric Boat (Mr. Veliotis) to advise him that the BREMERTON test program was being delayed because the company had not received contractual authorization from the Navy, yet the Navy could not even get the company to provide a maximum price proposal on this work. I did not want to authorize an unpriced change under the shipbuilding contract and leave the Navy vulnerable to a possible unsubstantiated claim for delay and disruption of the type we have previously received.

l. I was unable to contact Mr. Veliotis. No one at the shipyard could tell me how to reach him. The Supervisor of Shipbuilding did not know how to reach him. The hotel where he purportedly stays denied he was registered there, and then said that no information could be given out on Mr. Veliotis. His secretary, when contacted at home, said he was out on personal business and would return in about an hour.

m. Unable to reach Mr. Veliotis, I called Mr. David Lewis, Chairman of the Board of General Dynamics. His secretary agreed to get in touch with him and ask him to return my call which he did 45 minutes later.

n. Upon listening to the problem, Mr. Lewis said the company should not be holding up test programs on issues like this. He said he would take care of the problem, and said Mr. Veliotis was out of the country.

o. About 2400, 9/19/78, Electric Boat resumed work installing the replacement detector.

p. At 0900, 9/20/78, my representative at Electric Boat called Mr. Veliotis' office. His secretary said he was not in; that she was not sure where he was; that he might be on his way to St. Louis. In response to a question whether he was in the country, she said "yes."

q. At 1030, Mr. Veliotis' secretary called my representative at Electric Boat and told him that she was told to tell him that Mr. Veliotis was out of the country and that she had been trying to "protect Mr. Veliotis' interests."

10. The Navy cannot continue to do business on this basis. We cannot afford to hold up shipwork and tie up our technical people this way. Similarly Electric Boat's claims-oriented approach to shipbuilding impedes waterfront personnel at the shipyard who want to keep the work moving.

11. Another matter of concern is the frequent absence and "unavailability" of Mr. Veliotis in recent months. I understand that in the past month he has been away from the yard roughly two-thirds of the time. I cannot understand how he can thus run the yard efficiently. Nor is it proper that he insulates himself from the problems at the yard or from the Navy, his customer.

12. Mr. Lewis informed me last night that in an effort to work out a mutually satisfactory method of conducting business in future, he and Mr. Veliotis would visit me in Washington in the near future. I will inform you of the results of that meeting.

13. I also recommend that you take action along the lines I have recommended in prior correspondence with you.

H. G. Rickover
H. G. Rickover

Copy to:
Under Secretary of the Navy
Assistant Secretary of the Navy
 (Manpower, Reserve Affairs and Logistics)
General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Chairman, Navy Claims Settlement Board
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
2 Oct 1978

MEMORANDUM FOR COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Proposed agenda for meeting with General Dynamics' officials concerning administration of Navy shipbuilding contracts at Electric Boat

Encl: (1) Suggested issues to be resolved and commitments to be obtained from General Dynamics management in the forthcoming meeting between Navy and General Dynamics' officials

1. In my meeting with the Secretary of the Navy on 20 September 1978 he said that he was arranging a meeting in the near future with General Dynamics' officials regarding the growing problems affecting administration of Navy shipbuilding contracts at Electric Boat. He said specifically that the Chief of Naval Material and I would be present at the meeting. I presumed that you, as the Commander, Naval Sea Systems Command, would also attend.

2. The Chief of Naval Material informed me this morning that he has been asked to attend a meeting at 1100 tomorrow (October 3, 1978) involving the Secretary of the Navy, the Chairman of the Board of General Dynamics (Mr. David Lewis), and the General Manager, Electric Boat Division (Mr. P.T. Veliotis). Apparently neither you nor I are invited to the meeting.

3. The purpose of this memorandum is to submit a proposed agenda of items that the Navy needs to raise with General Dynamics' officials and commitments that should be obtained from them.

4. It appears from recent events that Electric Boat is determined to establish new terms and conditions for conducting day-to-day business. This effort appears designed to enable the company to recover some or all of the $359 million loss it recently agreed to absorb on the SSN 688 Class contracts. Specifically:

a. The company has been treating many routine items as the basis for future claims.

b. The company has been including new, large and arbitrary factors in pricing contract change proposals. This company strategy places the Navy in the position of either paying too much for the change; not being able to adjudicate the change promptly, as required by contract and Defense Department policy; or having to defer the work.

5. It is clear to me that the establishment of an open-ended basis for submitting future claims is the driving force behind the company's efforts in recent months.

6. The Navy, not Electric Boat, is the customer and should be treated accordingly. A contractor should not be able to obtain contracts on one basis and then attempt to change the rules midway through contract performance. Nor is it appropriate for a contractor to dictate the terms of future Navy contracts.

7. As a separate matter, the General Manager, Electric Boat Division has been frequently absent from the shipyard--apparently on other corporate business. In the past two months, for example, he has been away from the shipyard more than half the time. Further, he does not notify the Supervisor of his absence or where he can be reached.

8. Considering the amount and importance of Navy contracts at Electric Boat and the difficult nature of the work, it seems to me the Navy has the right to a full-time General Manager.

9. The day-to-day administration of shipbuilding contracts involves concepts which have evolved over years of actual experience. Thus, it would be very easy for a meeting of Navy officials not familiar with prior experience or the details of shipbuilding contracts to end up with agreements that would impede technical work, establish the basis for future claims, and weaken the Government's defense against such claims.

10. I recommend that you and I discuss the attached items with Admiral Whittle when he returns from Norfolk this afternoon.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Material

Revised 10/21/78 as indicated to
incorporate comments from Adm.
Bryan & Adm. Whittle

Agenda for meeting with General Dynamics and Navy officials regarding administration of Navy shipbuilding contracts.

Attachments: (A) NAVSHIPS ltr 08M-1103 dtd 15 Jul 1969 to Distribution
(B) NAVSHIPS ltr Ser 08N-2211 dtd 20 Dec 1971 to Distribution

1. The purpose of this meeting is to address the growing problems concerning the day-to-day administration of Navy shipbuilding contracts at Electric Boat. It is proposed that the following items be discussed and the contractor's concurrence obtained to the following:

A. Drawing revisions

(1) The use of non-deviation working drawings is essential in the construction of warships to control critical design details and ensure an accurate record of ship configuration. For nuclear-powered ships this practice started with the NAUTILUS at Electric Boat over 25 years ago.

(2) Despite the best efforts of all concerned to minimize drawing revisions, it is inevitable that a large number of these revisions will be required over and above those required to implement ship design changes. Drawing revisions are inevitable and needed to add technical and administrative notes; to reflect "as built" configurations; to correct drafting errors or omissions; to resolve interferences; to accommodate shipbuilder errors, shipbuilder requests for changes to facilitate construction, changes to contractor and Government-furnished equipment, etc.

In less critical areas, working drawings are not classified as "non-deviation"; on these, the shipbuilder may implement drawing revisions or not as he sees fit.

Enclosure (1)

(3) The Navy has contracted with its shipbuilders, within the original contract price, to accommodate revisions to detailed drawings throughout the life of a shipbuilding contract. However, drawing revisions which conflict with requirements of the Ship Specifications or Contract Guidance Drawings; or those which require ripout, rework, or a change to material already on order, are recognized by the Navy as constituting a change to the contract.

(4) Historically, Electric Boat has extrapolated bid prices for new ships based largely on actual cost experience with prior ships rather than on the specific myriad details contained in the thousands of working drawings required to build the ship. Thus, the shipbuilder's bid estimates have built into them the cost of handling thousands of routine drawing revisions in the traditional manner.

(5) Under Navy shipbuilding contracts, shipbuilders get pricing protection for uncertainties in design details, errors in estimating, and unanticipated problems, through contingencies in their estimates and through the cost sharing provisions between target costs and ceiling prices.

(6) The Navy cannot do business or tolerate a situation where a shipbuilder can exploit the design data he generates under cost-plus design contracts--or technical correspondence and communications from Navy prime contractors or from persons other than the Contracting Officer--as a basis for subsequent claims on shipbuilding contracts.

(7) Navy policy is to identify potential contract changes and settle the price and delivery implications of proposed contract changes before authorizing them. It is for this reason that the procedures set forth in the Changes clause of Navy shipbuilding contracts and in Attachments (A) and (B) were promulgated by the Navy.

(8) These procedures, which were agreed to by Electric Boat, make it clear that: (1) no one other than the contracting officer can authorize a change to a Navy shipbuilding contract; and (2) the shipbuilder must identify promptly any case where he believes he is being asked to do more than the contract requires so that the appropriate Government contracting officer can control what changes are made to the Government's contract and the extent to which the Government is increasing its liability for additional costs due to these changes.

(9) The Navy and its prime contractors provide considerable technical direction and assistance to the shipbuilder on a day-to-day basis. In many cases the Navy has worked with the shipbuilder to accommodate shipbuilder errors and provide other support without demanding reduced cost change orders or asserting claims against the shipbuilder, and so on.

(10) It is neither to the Navy's advantage nor to a shipbuilder's to funnel the thousands of routine technical documents required to build a ship through contract specialists and lawyers. To do so impedes the flow of technical data and construction.

B. Pricing of contract changes

(1) To administer shipbuilding contracts on a pay-as-you-go basis, the shipbuilder's proposal must include only those costs actually associated with the work.

(2) While the Navy is willing to pay for actual delay or disruption caused by a contract change, such costs should be demonstrable. Arbitrary factors or formulas to estimate delay or disruption are not an adequate basis for the pricing of changes.

(3) The recent EB practice of automatically including overtime premiums and inefficiency factors to the cost of change proposals is unreasonable and unacceptable.

(4) Contract changes, like drawing revisions, are inherent to ship construction. A responsible, experienced shipbuilder should make appropriate allowance for a normal level of Government initiated changes. It is not practicable to operate on the basis that each and every contract change disrupts the work force. Many are issued by the Navy well in advance, and provide adequate time for manpower planning.

(5) In cases where a contract change must be accomplished quickly, and therefore generates a requirement for overtime or actually causes delay in critical path operations, the Navy will accept such costs in the price of the change. However, these costs need to be specifically identified so that they can be evaluated on a case by case basis.

C. Repairs and modifications to Government-furnished reactor plant components

(1) Historically, whenever a delay or disruption to ship construction is not involved, Electric Boat has performed authorized repairs and modifications to Government-furnished reactor plant equipment under a separate cost reimbursement contract with the cognizant Naval Nuclear Propulsion Program prime contractor. Naval Nuclear Propulsion Program prime contractors who provided the equipment can authorize and pay for these repairs and modifications under a "Work Authorization" circuit, without the Government and the shipbuilder having to modify their shipbuilding contracts.

(2) The Work Authorization procedure works to the mutual advantage of the shipbuilder and the Government. But to remain viable it must be used whenever possible by the shipbuilder for routine repairs and modification, rather than trying to exploit these items for claims purposes under shipbuilding contracts.

D. Recommended commitments to obtain from General Dynamics' officials

a. The General Manager of Electric Boat will be assigned no other corporate responsibilities; his full time attention will be devoted to Electric Boat.

b. The Chairman of the Board of General Dynamics will issue written corporate policy direction to the General Manager, Electric Boat and he in turn to his subordinates as follows:

(1) To the maximum extent possible contract changes are to be priced out fully, and settled at the time the change is authorized by the Navy. The company will cooperate fully in this regard.

(2) In emergencies where contract action must be taken before a fully priced proposal can be prepared, the company will provide a maximum price proposal.

(3) The Work Authorization procedure will be used to the maximum extent possible by Electric Boat for repairs and modification to reactor plant equipment.

(4) Contract changes will be priced and settled on their individual merits. Contract change proposals will include only those costs associated with the change, or delay or disruption costs which can reasonably be expected ~~be shown~~ to flow from the change.

(5) Delay costs, if any, shall be substantiated in relation to impact on critical paths. Disruption, if any, shall be substantiated in relation to the specific work to be performed under the change. Special factors or percentages which cannot be substantiated in the company's records shall not be used in contract change proposals.

(6) Consistent with longstanding practice, drawing revisions which do not conflict with the Ship Specifications or with the Contract Guidance Drawings, and which do not require ripout, rework, or a change to material on order, are acknowledged as being within contract requirements and therefore will be implemented without a request for contract change.

(7) Government prime contractors, design yards and other third parties do not have authority to change Government contracts, constructively or otherwise. Therefore, in accordance with the Changes clause of its shipbuilding contracts and in accordance with Attachments (A) and (B), the company will identify promptly any action taken by third parties which the contractor considers as constituting a change to contract requirements, and obtain contracting officer authorization prior to commencing work.

(8) It is in the best long term interest of the United States Government and of General Dynamics that the administration of all of our contracts be on a completely open and aboveboard basis; all financial, contractual and technical matters must be handled on a straightforward basis with the Government.

(9) Electric Boat Division and corporate personnel recognize the Navy and other Government representatives as the customer and shall treat them in the same manner as any good business treats its customer.

(10) It is the responsibility of the corporation and Electric Boat Division to establish the propriety of practices questioned by the Navy or Government representatives without resorting to technicalities or loopholes.

(11) All corporate officials and General Dynamics Electric Boat personnel concerned with the performance and administration of Navy contracts should live up to the spirit of the settlement and not create the impression by words or

deeds that Electric Boat is a claims-oriented company looking for technicalities or loopholes through which future claims can be generated.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
3 Oct 1978

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Shipbuilding claims

1. I understand you are meeting with Mr. Lewis and Mr. Veliotis of General Dynamics at 1100 today regarding shipbuilding problems but that you do not want the Commander, Naval Sea Systems Command or me to attend.

2. As I informed you previously, Mr. Lewis had agreed to bring Mr. Veliotis to Washington to discuss with me the problems I was having on work under my cognizance. You later told me that you would set up a meeting with Mr. Lewis and Mr. Veliotis to address Navy-wide problems at Electric Boat and that I and others involved would be present at that meeting.

3. A major problem I foresee at Electric Boat is the likelihood of large claims on the TRIDENT shipbuilding program as well as additional claims on the SSN 688 Class program. We need to take action now to avert these claims. I have made specific recommendations in this regard in prior correspondence to you.

4. I assume that your meeting today is not in lieu of the meeting that the Chief of Naval Material, the Commander, Naval Sea Systems Command, and I need to have with Mr. Lewis and Mr. Veliotis to address ongoing problems at Electric Boat. In that regard it is most important that neither you nor Mr. Hidalgo say anything today which the Contractor can interpret as prejudging the case in their favor.

5. Over the years I have learned that the shipbuilders have found that they make out better by dealing with senior Navy officials who are not familiar with the history and details of shipbuilding contracts than by dealing with the working people who are directly responsible and knowledgeable. Former Secretary of the Navy Warner, however, handled these overtures by contractors effectively. He told the contractors to deal with that element of the Navy directly responsible for the contract in question and come back to see him after they had reached agreement or have both sides see him if they could not agree.

6. For this morning's meeting I suggest the following:

a. Make clear to Mr. Lewis and Mr. Veliotis that on matters pertaining to administration of Navy shipbuilding contracts they should deal directly with the Naval Sea Systems Command.

b. Avoid making any agreements, conceptual agreements or concessions at this meeting. In the context of some of the ongoing problems even innocent sounding statements of principle may have unanticipated implications.

c. Ensure that the working people in the Navy who are responsible for the Electric Boat contracts are fully informed of what transpires at your meeting.

H. G. Rickover

H. G. Rickover

Copy to:
Under Secretary of the Navy
Assistant Secretary of the Navy
 (Manpower, Reserve Affairs and Logistics)
General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Chairman, Navy Claims Settlement Board
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
13 April 1979

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Allocation of two FY 80/81 SSN's to Newport News in conjunction with award of the two FY 78/79 SSN's to Electric Boat

Ref: (a) COMNAVSEA Memo to SECNAV dtd 10 April 1979
(b) NAVSEA 02 Route Sheet to CNM dtd 11 April 1979

1. In reference (a), COMNAVSEA recommended entering into sole source negotiations with Newport News for the two FY 80/81 SSN's coincident with the award of the FY 78/79 SSN's to Electric Boat. Reference (b) provides detailed justification in support of this recommendation, emphasizing the need to award two ships to Newport News at this time, and for Secretarial approval to approach Newport News concurrently with the contract award. This would permit the Navy to take the initiative in this matter and deal with Newport News from the strongest possible negotiating position.

2. I understand that the Commander, Naval Sea Systems Command, the Chief of Naval Material, and the Chief of Naval Operations briefed you yesterday on the Navy's plan and that you desired to defer a decision with respect to awarding the FY 80/81 ships to Newport News until you could explore all the ramifications. The purpose of this memorandum is to emphasize the importance of getting whatever additional information is needed quickly so that the decision regarding the FY 80/81 ships can be made prior to the award of a contract for the FY 78/79 ships. I also want to bring to your personal attention other considerations which I believe militate in favor of proceeding as NAVSEA has recommended but which to my knowledge have not been highlighted in correspondence that has reached you.

3. References (a) and (b) effectively make the case for allocating the two FY 80/81 ships to Newport News from the standpoint of avoiding a gap in production. They also explain why, if the Navy does not set aside these two ships now for Newport News, it is unlikely the company would be able to compete successfully later for these ships--and more importantly, for new design submarines or possibly an increased submarine construction program now being studied for the early 1980's. In my view, these are compelling reasons for trying to allocate the two FY 80/81 ships to Newport News--particularly since,

according to NAVSEA estimates, Newport News would be able to build the FY 78/79 ships at less cost to the Government than Electric Boat. I do not know of any reason which would preclude Newport News from doing the same for the FY 80/81 ships.

4. In addition to the above, there is the issue of an apparent "buy-in" by Electric Boat in connection with the FY 78/79 two ship procurement. It is this issue which, although well documented in the contract files and negotiating minutes, needs to be brought clearly to your attention. Newport News has submitted a bid which is considered by NAVSEA to be realistic. The company has consistently built SSN 688 Class submarines for far less than Electric Boat and NAVSEA considers award of the FY 78/79 ships to Newport News would save the Government money. Yet, without allocation of both FY 80/81 SSN's, Newport News stands to lose not only the FY 78/79 contract but those to come in the future--all on the strength of Electric Boat assertions that in the future they will perform far more efficiently than they have in the past. In fact, Electric Boat purports to be able to build the FY 78/79 ships for far fewer manhours than projected in connection with the PL 85-804 settlement for completion of SSN 688 Class ships already under contract. NAVSEA had previously concluded the shipyard's estimates for PL 85-804 purposes were optimistic.

5. In these circumstances, how can Newport News or any other contractor conclude they have a fair chance to compete for the available business without cutting their own bids below realistic levels? Generally, I have taken the view that if a large contractor understands the job and decides to cut his bid for the sake of keeping work in his shop, the Government should avail itself of the lower price. However, the evolution of fixed price incentive fee pricing and escalation provisions has resulted in a situation where a shipbuilder can bid a lower target price that can result in a higher total cost to the Government. Such appears to be the case for the FY 78/79 SSN contract. Further, experience has shown that, at least in shipbuilding, the limited number of suppliers; the impracticability of default action; and the inability to obtain prompt resolution of disputes through the cognizant administrative and judicial forums--all lead toward the Government later having to pay a large part of any cost overruns through claims.

6. I recognize that neither NAVSEA, nor anyone else, can "prove" that Electric Boat cannot achieve the improvements they predict. However, I believe that the requirement for "proof" is too restrictive to be applied in assessing whether or not a contractor's bid constitutes a buy-in. One could argue that anything is possible until time eventually determines who was right and who was wrong. By then, however, we may be down to but one submarine shipbuilder--and perhaps the least efficient one.

7. With respect to the potential "buy-in" aspects of the Electric Boat proposal, I have learned that what looks like a duck, walks like a duck, and quacks like a duck, more often than not, is a duck. In this regard, the following is pertinent:

- The NAVSEA Technical Advisory Report (TAR) concluded that Electric Boat's "proposed total direct manhours for SSN 719 and SSN 720 are understated by approximately 1,400,000 per ship." Regarding the new Hull Cylinder Fabrication Facility, which accounts for a substantial portion of EB's projected manhour savings over the SSN 710 manhour estimate, the TAR states "there is a strong 'prima facie' case that the proposed savings are drastic, unrealistic, and not achievable." The TAR notes that "past SSN 688 Class experience, particularly at EBDIV, has painfully demonstrated that unfounded optimism based on undemonstrated improvements is disastrous to both the Government and the Contractor."

- The NAVSEA Pre-Award Survey Team considered the Electric Boat proposal to be "overly optimistic" and recommended to the Contracting Officer that no award be made to Electric Boat without substantiation of the proposed construction plan. The Pre-Award Survey Review Board, which forwarded the team's report to the Contracting Officer, concluded that Electric Boat "is not capable of constructing SSN's 719 and 720 as proposed without the unwarranted assumption of significant risk on the part of NAVSEA," and recommended against awarding a contract to Electric Boat.

- The NAVSEA Responsibility Panel determined that both EB and NN were capable of constructing the ships but stated it was not the responsibility of the panel to assess the adequacy of EB's manhour proposal. The panel noted that the Contracting Officer would address the manhour issue in his post-negotiation business clearance.

- The NAVSEA post-negotiation business clearance discussed Electric Boat's projections for reducing labor hours required to build SSN 688 Class submarines and stated: "...it is considered that the extent of such reductions has been significantly overstated to arrive at an unrealistically low target cost proposal." The clearance shows that Electric Boat has the lower bid when offers are evaluated using the factors identified in the solicitation (i.e. target price bid, projected escalation based on proposed delivery dates and other payables under the contract). However, it is further shown that the NAVSEA estimates of the end cost to the Government of the two offers results in the Newport News ships costing less than Electric Boat's. The difference results from the cost sharing provision of the proposed contract, with NAVSEA paying 80% of the expected Electric Boat overrun.

8. Notwithstanding the above, NAVSEA concluded it was bound by the terms of the solicitation to award both FY 78/79 ships to Electric Boat. To discourage deliberate underbidding in future and the havoc this could cause to the Navy procurement process, I believe the Navy would be better off in the long run awarding the FY 78/79 ships to Newport News, or alternatively to award one ship to each. In this way, contractors in the future might think twice about "winning the contract at all costs."

9. I am aware, however, that because of the terms of the solicitation, Electric Boat might be able to sustain a bid protest and that this could prove disruptive to submarine construction. However, having decided to award the FY 78/79 ships to Electric Boat in order to sustain the credibility of the solicitation, it becomes all the more important for the Navy to take the initiative in contacting Newport News along the lines set forth in reference (a) immediately upon award of the contract to Electric Boat. In that way, the Navy will stand the best chance of salvaging credibility for its procurement process as well as ensuring a second submarine construction yard. This act would show that the Navy wants to keep Newport News in the business and is willing to take steps to see that the company is not frozen out of the business by a competitor who appears to be submitting an unrealistically low bid.

10. If the Navy proceeds to award the FY 78/79 ships to Electric Boat without simultaneously contacting Newport News with respect to the FY 80/81 ships, Newport News might protest the Electric Boat award on the basis that the total cost to the Government would be less if the ships were awarded to Newport News. If the Navy then approached Newport News to negotiate allocation of the FY 80/81 submarines it might appear that the Navy was pressured into sole source negotiations, thus sending an unintended message to contractors that it pays to protest.

11. I consider it essential that the Navy face up now to the apparent "buy-in" situation at Electric Boat. The Defense Acquisition Regulation provides no clear guidance with respect to handling a situation such as this. Faced with an apparent buy-in, the legal and contractual experts inevitably conclude the Government has no alternative but to make the award to the apparent low bidder. Later, when the claims come in, those who made the award will be criticized for their actions. But as usual, they will probably no longer be around.

12. Awarding the FY 80/81 ships to Newport News will at least reflect some effort on the part of the Navy to discourage underbidding. In addition, it may prove useful in the event of future claims by Electric Boat to be able to evaluate these claims in the light of the very same ships having been built by Newport News in the same time frame.

13. For the reasons explained above, I strongly recommend that you approve the reference (a) proposal with respect to Newport News before the Navy awards the FY 78/79 ships to Electric Boat.

H. G. Rickover

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
08H-502
11 January 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Adjudication of delays in Ingalls submarine overhaul work

Ref: (a) My memo to Chief of Naval Material dtd 2 Mar 79
(b) My memo to you Ser 080-C16 dtd 20 Apr 79

1. As you know, I have been concerned over poor performance by Ingalls Shipbuilding for several years. In references (a) and (b) I discussed many examples of shipyard problems with the GATO and SUNFISH overhauls. In addition, I have written the President of Ingalls Shipbuilding on several occasions pointing out numerous deficiencies in reactor plant overhaul work. Because of my concern, I recommended in reference (b) that a team be established to review Ingalls ability to complete safely the work remaining on the last two overhauls assigned to the shipyard. Subsequently, you established a NAVSEA Special Submarine Review Team which visited Ingalls during May and November to review work in GATO and SUNFISH and recommend actions to properly complete the overhauls of these ships.

2. In addition to Ingalls ability to properly perform the remaining overhaul work, I am also concerned over the adjudication of responsibility for the long delays in overhaul completion which are occurring with GATO and SUNFISH. Recommendations made by the Special Submarine Review Team did not address this area of concern. By present estimates, GATO will be 610 days and SUNFISH 347 days late to their original contract delivery dates. To date, SUPSHIP and Ingalls have adjudicated responsibility for only 48 days of the 610 days of delay estimated for GATO. Responsibility for any SUNFISH delay has not yet been adjudicated. Due to the numerous and recurring deficiencies which have been identified with Ingalls performance, I would be surprised if the Government is responsible for very much, if any, of the delay on the two overhauls.

3. A local SUPSHIP/Ingalls procedure (commonly called the milestone agreement) is the basis by which responsibility for delay occurring to GATO and SUNFISH is evaluated and negotiated.

This agreement provides a framework for Ingalls to submit delay proposals and for the parties to adjudicate delay responsibility at predetermined overhaul events or milestones (e.g. loop fill and criticality). However, the Ingalls proposals submitted to date indicate that it will be difficult to negotiate a fair settlement of delay responsibility for GATO and SUNFISH. In fact, the Ingalls delay proposal submitted in May 1978 for the GATO loop fill milestone has not yet been adjudicated. Examples of difficulties encountered in adjudicating delay responsibility for these ships are shown by the following:

a. Ingalls delay proposal for the SUNFISH loop fill milestone alleged Government responsibility for delays clearly the responsibility of the contractor.

b. In its delay proposals, Ingalls has been reserving the right to claim further delay resulting from other work in these ships occurring during the same time frame. Delay settlements subject to such reservations are meaningless and merely place the Government in double jeopardy.

c. Ingalls most recent delay proposal failed to discuss the months of delay caused by the installation of fasteners in SUNFISH which did not meet specifications, a matter for which the contractor is responsible. In the SUNFISH delay proposal submitted to the Supervisor on 30 October 1979 Ingalls suggests the possibility of a subsequent claim against the Navy for this delay. The Ingalls proposal stated: "The Contractor requests to reserve its rights to delay with respect to investigations and resolution of all fastener problems on SUNFISH." I expect the next GATO delay proposal to include similar statements.

4. I understand that in August 1979 the Supervisor of Shipbuilding established a submarine delay evaluation group which should enable the Government to better assess responsibility for delays which have occurred. While this action is a step in the right direction, it is obvious to me that responsibility for the 957 days of delay which are occurring with both GATO and SUNFISH will not be easily settled by the Supervisor. Since the Navy is no longer assigning SSN overhauls to Ingalls, the shipyard will have every incentive to be obstreperous in its negotiations with the Supervisor. In addition to alleging Government responsibility for much of the delay as a method to increase contract fees, Ingalls may try to create the impression that the delays were the Navy's fault and not indicative of the shipyard's actual contract performance.

5. It is important that SUPSHIP perform a complete and accurate analysis of Ingalls delay proposals. To help ensure that delay proposals for GATO and SUNFISH are properly analyzed and negotiated, I consider that NAVSEA should review the Supervisor's submarine delay evaluation group to ensure it:

a. has the capability to thoroughly and critically analyze Ingalls delay proposals, and

b. insists on receiving complete and substantiated proposals from Ingalls without any "reservation of rights" to claim additional Government responsibility for delays.

6. In view of the amounts of delay time and money involved with Ingalls late performance of overhaul work, it may be advisable to obtain one complete delay proposal from Ingalls for each ship rather than continue to analyze and negotiate individual milestone proposals. Further, I consider that NAVSEA should review and approve all proposed delay settlements.

7. I would appreciate being advised of your action on this matter.

H.G. Rickover

Copy to:
SEA 92
SEA 02

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
921/LMG/cro
Ser 335-921
29 Jan 1980

MEMORANDUM FOR THE DEPUTY COMMANDER, NUCLEAR PROPULSION DIRECTORATE

Subj: Adjudication of Delays in Ingalls Submarine Overhaul Work

Ref: (a) NAVSEA 08 memo of 11 January 1980

1. In response to your memo of 11 January 1980 (reference (a)) I concur with your conclusions and recommendations in regard to the adjudication of delays in Ingalls submarine work.

2. As noted, the Supervisor established a Submarine Delay Evaluation Team on 6 August 1979. The composition of the team consists of a team leader, an experienced negotiator from the SUPSHIP Contracts Department, legal counsel,three Production Controllers who are familiar with the history of the two overhauls, two Quality Assurance Specialists, and one Technical Analyst who has experience in preparing Technical Advisory Reports. SUPSHIP PASCA is scheduled to give a Program Review Presentation to NAVSEA on 26 February 1980 during which the Delay Evaluation Team's ability to thoroughly and critically analyze all areas of Ingalls' delay proposal will be reviewed. If residual concern exists after this presentation, consideration will be given to an on-site review by a NAVSEA team.

3. I concur with your recommendation to insist on the receipt of complete and substantiated proposals from Ingalls without any "reservation of rights" to claim additional Government responsibility for delays. The Supervisor is in the process of implementing this action. In addition, the Supervisor has recently concluded that it would be in the best interest of the Government to reject the proposals on hand and to require Ingalls to resubmit one delay proposal for each of the overhaul contracts after redelivery. This action is also in process. After the receipt of the revised Ingalls proposals and analysis by the SUPSHIP Team, the Supervisor will obtain NAVSEA approval subsequent to negotiations and prior to final settlement.

C R Bryan
C. R. BRYAN

Copy to:
SEA 92
SEA 02
SEA 07

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

6 February 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Proposed NAVSEA position on the Naval Ship Procurement Process Study recommendations to expedite the settling of shipbuilding contract changes through various techniques for pricing delay and disruption

1. During the past year, the Naval Sea Systems Command has been commenting on recommendations contained in the Naval Ship Procurement Process Study (NSPPS) with the aim of improving ship procurement practices. NAVSEA has not yet reached a final position on the following NSPPS recommendations regarding pricing of contract changes:

a. "Continue the work aimed at devising a formula method for pricing delay and disruption costs," and,

b. "Experiment with techniques for pricing delay and disruption on a quarterly or semiannual basis rather than as an element of individual changes."

The purpose of this memorandum is to recommend that NAVSEA not adopt these two recommendations.

2. The controversy over delay and disruption in Navy shipbuilding contracts arose primarily in connection with the large shipbuilding claims submitted against the Navy during the past decade. In many of these claims, shipbuilders alleged that Government changes, both formal and constructive, disrupted shipyard work and were the predominate cause of delivery delays. In many cases the shipbuilders were not able to attribute the claimed delay and disruption to specific changes. Thus the large sums claimed for the effects of delay and disruption provided a way for shipbuilders to fill the large gap between the amounts they could substantiate as Government liability and the claim total they decided to submit.

3. Facing the prospect of losing money if the large claims outstanding were unsuccessful, some shipbuilders became reluctant to price out even routine changes on their merits and a large backlog of unadjudicated

changes developed. These shipbuilders wanted to settle a price for the changes but at the same time reserve the right to submit a claim at a later date for delay and disruption. This practice, known as partial adjudication of changes, guarantees shipbuilders the basis for subsequent claims in almost any amount. Shipbuilders, and even Government personnel, blamed the large backlog of unadjudicated changes that developed during the claims era on an inability to measure the alleged Government responsible delay and disruption costs. Actually shipbuilders had no intention of settling their claims or contract changes on their merits; the alleged problem of pricing delay and disruption, however, was a convenient explanation for the failure to settle the claims or contract changes.

4. A year and a half ago, the Secretary of the Navy settled all the large outstanding Navy shipbuilding claims by granting additional amounts as extracontractual relief under P.L. 85-804. Despite these claim settlements, some shipbuilders persist in their attempts to gain Government acceptance of the disruption theories put forth in their previous claims — namely that all changes involve delay and disruption; that the Navy and shipbuilders cannot price changes promptly because of an inability to measure and price this delay and disruption; and that shipbuilders are not adequately compensated for changed work unless delay and disruption is included as a separate pricing element.

5. In an effort to be responsive to these charges, Navy representatives at various shipyards have been attempting to reach agreement on additional factors to be added to cost estimates, either in consideration of delay and disruption or to mitigate these effects. In some cases formulas have been developed locally on a trial basis to develop factors for pricing delay and disruption on individual changes for which delay and disruption cannot be directly estimated, or periodically to adjust the contract to cover the delay and disruption for all changes issued in a prior period.

6. Adjudicating contract changes by incorporating special factors has been defended on the basis of foreclosing future claims against those changes. Yet only a very small fraction of the amounts claimed under the recently settled

shipbuilding claims stemmed from formal contract changes. The balance was attributed to alleged constructive changes. Thus, even if a shipbuilder is willing to settle contract changes today with only a small amount added for unsubstantiated delay and disruption, he does not in any way foreclose himself from later disputing the underlying assumptions and claiming far larger amounts on contract changes or after-the-fact claims for constructive changes. In the same way, agreements to partially adjudicate changes with periodic settlement of delay and disruption require the continued cooperation of both parties. Such agreements will not hold up if we again find ourselves in a claims situation and will only serve to increase the Government's vulnerability to future claims.

7. The Navy has always been willing to pay for bona fide ship delay caused by Government responsible items, including changes and all reasonable costs associated with such delay. But the Navy should not include in the pricing of changes, special factors to compensate for subtle effects of delay and disruption which cannot be substantiated.

8. The pricing of Navy shipbuilding contracts has been, and will continue to be, a relatively crude approximation of the work to be performed based on the shipyard's past experience in constructing ships over many years. Contract changes have been an inherent part of that experience. It makes no sense to price huge contracts on the basis of so many manhours and material dollars per ton and then administer them as if each and every manhour to be used had been carefully planned and calculated at the outset. In this regard, it is worth reflecting on the following:

a. Historically, contract changes have amounted to only a small percentage of ship construction costs - somewhere in the neighborhood of 5 percent. With all the other uncertainties inherent in pricing shipbuilding contracts and the liberal protection these contracts provide in the form of large target cost-to-ceiling price spreads and incentive cost sharing provisions, why should a shipbuilder be concerned about further refining the accuracy of pricing 5 percent or less of his work?

b. If delay and disruption are inherent in contract changes, and changes are inherent in naval ship construction, are not the costs of delay and disruption — to the extent they exist — automatically built into historical costs upon which the prices of most shipbuilding contracts and contract changes are based?

c. How can shipbuilders allege they have insufficient manpower to accommodate the changes inherent in ship construction when they continually represent to NAVSEA that they have adequate facilities and manpower to accommodate new contracts?

d. In comparison with basic contract work, changes are generally better defined at the outset, accomplished over a much shorter time period, and involve fewer uncertainties. Yet at several major shipyards, Navy contracting officers routinely add to the negotiated price of contract changes a target cost-to-ceiling price spread comparable to that used on the basic shipbuilding contract. Under these circumstances, how can shipbuilders legitimately contend they are not being fairly compensated for changed work?

e. Why is it that prior to the 1970's, the era of the large, omnibus shipbuilding claims, the Navy and its shipbuilders were able to price contract changes without resorting to formulas and special factors for unsubstantiated delay and disruption?

f. What kind of precedent will the Navy establish if it routinely increases the prices of its shipbuilding contracts in recognition of costs that cannot be substantiated?

10. With regard to the above, it is important to recognize that to the extent unsubstantiated delay and disruption costs exist, they are reflected in the costs reimbursed under Navy contracts, the same as for other allowable costs under the shareline pricing provisions of the contract. The only issue involved therefore is whether in negotiating a contract price adjustment for the effects of a change, the Navy must include a separate factor in consideration of unsubstantiated delay and disruption. To do so, in my opinion, would be a grave mistake.

11. In recent years there has been a disturbing tendency by shipbuilders and by the Navy itself to complicate

unnecessarily the administration of shipbuilding contracts. Shipbuilding contracts have become a playground for procurement theorists. Time and again the concerns being raised by some shipbuilders seem to be prompted by their lawyers or contracts people, many of whom have been involved in shipbuilding claims. Their arguments, while perhaps defensible in an academic sense, assume a degree of sophistication which does not and should not exist in the pricing and management of shipbuilding work.

12. A theoretical approach to contract administration is counter productive and diverts attention from primary tasks. But if the Navy is to pursue such a policy it should do so consistently including occassions when the Navy would benefit; e.g. on that basis the Navy should stop automatically paying large target cost-to-ceiling price spreads on contract changes, and should insist that for contract pricing purposes historical cost data be purged of "the effects of delay and disruption", and so on.

13. I recommend we waste no more time in pursuit of "accurate" pricing of contract changes. I am aware that various pricing schemes and mathematical models have been born of this effort. These have been complex, subjective, and built around assumptions and figures that could easily be challenged. It is nonsense to believe that the compounded total of such assumptions and subjective judgements could in any way improve the pricing of changes or that letting our own people and shipbuilder personnel get bogged down in such efforts will be to our mutual interest. The complexity and subjectivity of such schemes would in my opinion, result in more claims and contract disputes, not less.

14. Based on the above, I believe NAVSEA should at once adopt the following position with regard to pricing delay and disruption effects of contract changes, and make this position clear to shipbuilders and Navy contracts personnel:

- Separate pricing factors for delay and disruption should be allowed in contract change proposals when the ship delay and disruption can be directly attributed to the change and directly estimated and substantiated.

- Delay and disruption effects of changes that cannot be directly estimated and substantiated will not be included as a separate pricing element of shipbuilding contract changes. The cost sharing provisions of fixed price incentive shipbuilding contracts are considered by NAVSEA to provide more than adequate protection for such effects.

- Partial adjudication of contract changes with subsequent settlement of delay and disruption is contrary to Navy and Defense Department policy and should not be done.

15. I consider that rapid adoption of the measures outlined above will be of immediate and lasting benefit to the Navy and to shipbuilders and will eliminate much of the acrimony and confusion which has plagued Navy ship procurement in recent years. By adopting the above suggestions, shipbuilding officials and the Navy will be able to use their technical people to their proper purpose — designing and building ships — instead of fighting legal battles engineered by lawyers who benefit most from the confusion they have introduced.

17. I would appreciate being informed of what action you take in this matter.

H. G. Rickover.
H. G. Rickover

Copy to:
NAVSEA 09
NAVSEA 90
NAVSEA 02
NAVSEA OOL

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
27 February 1980

MEMORANDUM FOR THE DEPUTY COMMANDER, NUCLEAR PROPULSION DIRECTORATE

Subj: Proposed NAVSEA Position on the Naval Ship Procurement Process Study recommendations to expedite the settling of shipbuilding contract changes through various techniques for pricing delay and disruption

Ref : (a) Deputy Commander, Nuclear Propulsion Memorandum of 6 Feb 80

1. Reference (a) provided your recommendations that NAVSEA not accept the Naval Ship Procurement Process Study (NSPPS) conclusions concerning continuation of work aimed at devising a formula method for pricing delay and disruption costs and experimentation with quarterly or semiannual techniques for pricing such costs. You further expressed the belief that NAVSEA should adopt the following position with regard to the pricing of delay and disruption effects of contract changes:

a. Separate pricing factors for delay and disruption should be allowed in contract change proposals when the ship delay and disruption can be directly attributed to the change and directly estimated and substantiated.

b. Delay and disruption effects of changes that cannot be directly estimated and substantiated will not be included as a separate pricing element of shipbuilding contract changes. The cost sharing provision of fixed price incentive shipbuilding contracts are considered by NAVSEA to provide more than adequate protection for such effects.

c. Partial adjudication of contract changes with subsequent settlement of delay and disruption is contrary to Navy and Defense Department policy and should not be done.

2. Your discussion of the history of the delay and disruption issue and your perceptions of factors involved in that issue were very clear. I propose to adopt for use in the NAVSEA Position Paper the following basic principles of reasonable cause and effect relationship that you espouse:

a. Prices for contract changes must be adequately supported for all cost elements including delay and disruption. It is recognized that,although delay and disruption impacts are known,effects for some changes, such impacts at times cannot be directly estimated or verified from the shipbuilders cost records. However, though delay and disruption costs are difficult to estimate, they cannot be ignored in reaching equitable settlements for implementing contract changes. In such cases, inclusion of delay and disruption costs in change settlements is considered appropriate:(1) when it is reasonable to conclude that delay and disruption did occur as result of a change, and (2) when delay and disruption costs can be estimated reasonably, even by use of pricing factors, provided an adequate basis is established to support the reasonableness of such factors. Use of a formula to develop pricing factors would be acceptable if the development of the formula itself stands the test of being based upon reasonable substantiation.

b. In pricing changes under fixed price incentive contracts, the target cost to ceiling price spread should be established to reflect the risk and uncertainties associated only with changed work. The basic contract price spread should not automatically be used for pricing the change. Equally, however, the spread should not automatically be considered full compensation for delay and disruption cost impacts, merely because such impacts are difficult to estimate.

c. Partial adjudication of contract changes will be used only in exceptional circumstances, in accordance with applicable DAR and NCD policy. In accordance with SACAM, ACOs at SUPSHIPs are not authorized to settle contract changes partially without specific NAVSEA approval.

d. NAVSEA experience to date with such formula methods of pricing indicates that they have limited application in unique and exceptional circumstances. Their use will be subject to stringent NAVSEA Headquarters control. I have directed the Deputy Commander for Contracts to review current practice to ensure conformance with the discussion herein.

3. I trust that you will find the NAVSEA position set out above responsive to your expressed concern.

Very respectfully,

C R Bryan

C. R. BRYAN

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

31 March 1980

Mr. David S. Lewis
Chairman of the Board
General Dynamics Corporation
Pierre Leclede Center
St. Louis, Missouri 63105

Dear Mr. Lewis:

My letters to you of January 25, 1980, and February 12, 1980, discussed quality control problems at the Electric Boat Division of General Dynamics. I expressed my concern with the overall attitude and the degree of emphasis on quality control and attention to details at Electric Boat. I noted that submarines have been delayed for months and continue to be delayed because of quality control problems and lack of attention to seemingly minor details.

Subsequent to my letters discussed above, there have been additional examples which indicate the attitude of the current Electric Boat management toward dealing with nuclear submarine construction problems. Within the last two months, the General Manager of Electric Boat cancelled the long standing weekly meetings with the submarine commanding officers and stopped submitting critical items reports to me. Both of these practices were started early in the naval nuclear propulsion program and are used at all shipyards performing naval nuclear ship work.

The weekly meetings with the submarine commanding officers were established to provide the shipyard manager with first hand information on shipyard performance directly from the ultimate customer -- the ship's commanding officer. The prospective commanding officers of submarines under construction spend considerable time observing construction and testing in their submarines. Their observations have been particularly useful in shipyards where the shipyard manager does not frequently inspect the ships, and where he cannot know what is going on in individual ships as well as do the commanding officers.

Since the inception of the Navy nuclear propulsion program, the weekly critical items reports have been used to identify problems and obtain my assistance, if necessary. The reports go directly from the top contractor official to me and enable me to ensure that prompt action is being taken.

I recognize that the value of both the shipyard weekly meetings with the ship commanding officers and the critical items reports depends strongly on the attitude of the shipyard manager. If the manager does not desire to hear about problems from his customers, the ship commanding officers, or obtain my assistance, as appropriate, simply to hold pro forma meetings and submit weekly letters is a waste of time.

I stated in my letter to you of January 25, 1980, that unless steps are taken to redirect the attention of Electric Boat management to details and necessary corrective action, I expect more problems for both General Dynamics and the Navy. For this reason, I am bringing the matters discussed above to your personal attention.

Sincerely,

H. G. Rickover

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
24 June 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Nuclear Submarine Work at the Electric Boat Division of General Dynamics Corporation

Ref: (a) Electric Boat letter R38101 dated 4 June 1980

Encl: (1) NAVSEA letter Ser 08N-604 dated 6 June 1980

1. In October 1977, General Dynamics Corporation replaced the top management of its Electric Boat Division. New managers were selected by General Dynamics for all the major functions affecting work in the shipyard including production, quality control, and engineering. The new management, after reviewing the situation at Electric Boat, advised the Navy in February 1978 of new estimated delivery dates for all the submarines, both SSN688 Class and TRIDENT, under construction at Electric Boat. Major problems have prevented the new Electric Boat management from achieving its schedules, and I expect will continue to adversely impact submarine construction at Electric Boat.

2. Instead of working with the Navy to solve the problems delaying submarines at Electric Boat, the Electric Boat management in its dealings with the Navy appears to be concentrating on financial and contractual issues. For example, recently Electric Boat has created an entire new series of problems by claiming unreasonable TRIDENT ship delays for minor work items. Reference (a) describes an instance where Electric Boat alleged that installation of a wire rope retainer for an engine room deck hatch cover would result in a 14 day delay in delivery of the lead TRIDENT submarine. As noted in enclosure (1), a naval shipyard estimated the work could be accomplished in less than two hours. There have been many other claims of this type from Electric Boat recently and these issues are taking up the time of many Navy and shipyard people and detracting these people from the real job of getting the ships built properly.

3. In the area of quality control, inspection and repair of defective structural welds continue to delay submarines. This structural welding problem which was discovered by Electric Boat in late December 1979 was originally considered by Electric Boat to be a limited situation attributed to inadequate inspection by certain personnel. The BREMERTON (SSN698), which was ready in other respects for sea trials when the welding problem was discovered, is still being repaired and Electric Boat has not informed the Navy when the ship will be ready for sea trials.

4. Delays at Electric Boat are also aggravating the Navy's personnel problems because the BREMERTON and other delayed submarines have essentially full Navy crews assigned. In effect, the construction delays at Electric Boat are tying up a large number of critically needed nuclear submarine personnel. The Navy

crews train for several months in the shipyard in anticipation of going to sea. The long delays result in excessive and unplanned personnel turnover with a net reduction in overall crew experience level. This causes the Navy to incur large costs for unnecessary recruiting and training which are generally not recognized, and the trained men leave the Navy before use can be made of them. A formal request by the Naval Sea Systems Command to Electric Boat on 22 May 1980 for current schedule information has not been answered, and the Navy is unable to make realistic schedule estimates independently.

5. In my opinion, the problems discussed above are indicative of a more fundamental difficulty in dealing with Electric Boat. The contractor apparently has adopted a policy of dealing with the Navy as an adversary rather than as its sole customer. It appears that Electric Boat management attention is directed at laying the basis for future claims, and the actual performance of the work is being neglected. As I reported to you in my memorandum of 4 March 1980, Electric Boat has implied in formal correspondence that the Navy shares responsibility for the structural welding problem. In an effort to clarify this issue, the Naval Sea Systems Command on 2 May 1980 formally requested Electric Boat to state its intentions with regard to pursuing claims on the welding problem, or any other problems. Despite a follow-up request on 10 June, no reply has been received from Electric Boat.

6. As you know, the Navy is committed to Congress to administer shipbuilding contracts with Electric Boat and other shipbuilders on a pay-as-you-go basis, in order to obviate future shipbuilding claims of the type you settled in 1978. To help avoid recurrence of large claims for events allegedly occurring many years before submission of the claim, the Navy drafted a "Notification of Changes" clause for use in new contracts. This would "obtain prompt reporting of any conduct which the contractor considers would constitute or would require a change to the contract." By obtaining prompt reporting of potential changes, problems can be resolved as they arise and the new contracts administered on a current basis.

7. As revised during negotiations with Electric Boat, the "Notification of Changes" clause still provides for the shipbuilder to notify the Navy promptly of any conduct the shipbuilder considers to constitute or to require a change to the contract. In addition, by the end of the first and third quarters of each calendar year, the shipbuilder is required to deliver a full and final claims release for all conduct occurring through the end of the second and fourth quarters respectively, of the preceding year - e.g., by 31 March 1982, the shipbuilder is to deliver a claims release for conduct through 30 June 1981. The shipbuilder may review his operations to determine if any conduct entitles him to a contract change, but any such conduct must be specifically identified and listed as an exception to the claims release. Thus, the clause requires periodic claims releases to be delivered to the Government covering conduct occurring during the interval between 9 and 15 months prior to the claims release.

8. Both Electric Boat and General Dynamics officials profess to share the Navy's desire to keep contracts current and on a pay-as-you-go basis. These officials also deny that the company is "setting up" the Navy for subsequent claims. Yet the Navy and Electric Boat are now at an impasse in negotiations over the "Notification of Changes" clause for the new TRIDENT and SSN688 Class contracts. Although

Electric Boat has appeared to make concessions during negotiations, the company is nevertheless holding out for a provision which would create a large loophole in the clause. Specifically, Electric Boat now insists that only conduct "under the contract" will be identified or released. By adding the words "under the contract" to the conduct covered by the "Notification of Changes" clause, Electric Boat could submit a claim, years after the fact, by alleging that the claim resulted from Government conduct under another contract. This type of claim, known as a cross-contract impact claim, would not be barred by the semi-annual claims releases required by the "Notification of Changes" clause should the loophole Electric Boat desires be included in the clause.

9. This loophole, which excludes cross-contract impact claims from the claims releases required to be delivered by the "Notification of Changes" clause, would pave the way for the company, at some later date, to assert a large after-the-fact claim alleging that the new SSN688 or TRIDENT contracts were impacted by Government actions under the existing TRIDENT or SSN688 contracts or under other Government contracts. The Navy faced large after-the-fact shipbuilding cross-contract claims in the 1970's. One such claim was a multi-million dollar cross-contract impact claim from General Dynamics under several submarine construction contracts. The Navy was forced to litigate it for years during the 1970's. This General Dynamics claim was dismissed by the Court of Claims. In another case, the Armed Services Board of Contract Appeals (ASBCA), in 1978, ordered the Navy to pay $50.4 million of a $131.5 million cross-contract impact claim from the Ingalls Shipbuilding Division of Litton Industries.

10. Electric Boat contends it cannot always identify cross-contract impact problems within the time frame allowed by the "Notification of Changes" clause for delivering the claims releases; therefore, Electric Boat will not grant a full claims release. It is inconceivable that Electric Boat, or any other yard building Navy ships, cannot identify any significant cross-contract impact within a minimum of 9 months after the event giving rise to the alleged impact.

11. A second loophole Electric Boat is seeking for new contracts is a clause that would grant the right to a contract price and delivery adjustment for "changes in law". Were the Navy to agree to such a clause, this would be sought by all other contractors, and would provide a convenient avenue for Government contractors to reprice their contracts by attributing their own problems to changes in law. The effects of statutory and regulatory changes on a contractor's operations are subjective judgments not susceptible to measurement. Consequently, agreeing to this loophole would be an open invitation to claims in all Government contracting.

12. If the Navy allows these loopholes, it will be inviting omnibus claims of the type that have caused such vast troubles in the past. Moreover, Navy officials will then be unable to provide Congress with assurance that the Navy is administering contracts on a pay-as-you-go basis. Past experience has demonstrated that when Navy managed programs become subject to large, after-the-fact claims, it is the Navy, not the shipbuilders, that bears the brunt of Congressional dissatisfaction.

13. The "Notification of Changes" clause proposed by the Navy imposes no unreasonable burdens on a shipbuilder. While the clause requires prompt notification of potential changes, the shipbuilder does not lose entitlement to a change for failure to do so, provided he identifies the conduct requiring the potential change within 9 - 15 months after the conduct occurs. In the same vein, the Navy's position in rejecting the shipbuilder's proposed "Changes in Law" clause is consistent with the standard, and I believe sound, Government procurement practice of holding contractors financially responsible for complying with applicable laws and regulations.

14. In view of the current situation with Electric Boat, I consider that senior General Dynamics officials may try to persuade you and other senior Navy officials to abandon the Navy's efforts to close these loopholes. Electric Boat seems to be of the opinion that if the company holds fast to its present position, the Navy will have to give in because of its desire to award the contracts quickly. On the other hand, if company officials understand that you are fully and firmly behind the Navy's efforts and that you intend to honor the Navy's Congressional commitment to keep shipbuilding contracts current, I believe they will accept the Navy position, and we can then proceed with negotiation and award of our shipbuilding contracts.

15. In sum, there are serious problems affecting existing submarine construction contracts at Electric Boat and the Navy's ability to place new contracts with that company. The Naval Sea Systems Command is attempting to resolve these problems with the company; I do not believe any action by you is required at this time. However, if Electric Boat or General Dynamics officials attempt to enlist your support, I urge that you make clear to them that you fully support the Naval Sea Systems Command. This is necessary to ensure that the contracts now being negotiated do not contain loopholes which would leave the Navy once more open to large, after-the-fact claims.

H. G. Rickover
H. G. RICKOVER

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
N00024-75-C-2014
Ser 08N-604
6 June 1980

From: Commander, Naval Sea Systems Command
To: General Manager, Electric Boat Division
General Dynamics Corporation
Groton, Connecticut
Via: Supervisor of Shipbuilding, Conversion and Repair, U. S. Navy
Groton, Connecticut

Subj: TRIDENT (SSBN 726 Class); Contract N00024-75-C-2014; Propulsion Plant Drawing Revisions

Ref: (a) Electric Boat letter R-37811 dated 28 April 1980
(b) Electric Boat letter R-38101 dated 4 June 1980

1. Background:

a. In reference (a) Electric Boat stated:

> "...effective April 28, 1980, Electric Boat Division will not proceed with accomplishment of the work of any Non-Deviation Design Data Revisions received from Design Agent until an assessment has been made regarding entitlement to compensation. When Electric Boat Division finds that there is a requirement for an equitable adjustment, the government will be so notified and work will not be released to the shipyard until a fully priced modification to the contract has been adjudicated."

b. Since April 28, 1980, Electric Boat has notified the Supervisor of Shipbuilding that accomplishment of the work required by several non-deviation propulsion plant drawing revisions (Engineering Notices) will require an equitable adjustment to the subject contract. In some cases, Electric Boat has alleged that accomplishment of even minor work items would cause delay in delivery of the OHIO (SSBN 726) with the estimated delay costs far exceeding the cost of the changed work. Upon review of the Electric Boat's proposals, the Navy concluded that the minor nature of the work did not justify any delay. Therefore, the Navy authorized the work only on the basis that there would be no ship delay.

c. Reference (b) is a recent example of the problem. Reference (b) states that Electric Boat's preliminary evaluation of the schedule effect of accomplishing the work associated with Engineering Notice 6305, Rev. A, will cause a delay in delivery of the OHIO (SSBN 726). Reference (b) states:

ENCLOSURE(1)

> "In order to minimize the delay caused by this change, the work will be accomplished after Power Range Testing but prior to Sea Trials. The accomplishment of this work will result in a two (2) day delay to Dock Trials. Due to the requirement to commence Sea Trials on Sunday, the two (2) days of additional work produces a seven (7) day delay to Sea Trials. Resequencing and rescheduling the fourth Sea Trial work period to avoid being at sea over Christmas and New Year's Day, and to enable INSURV Inspection to commence on a Tuesday, causes an additional seven (7) days delay resulting in a total delay of fourteen (14) days."

2. NAVSEA Discussion:

a. Engineering Notice 6305, Rev. A involves a minor work item. It requires the addition of a wire rope (approximately 36 inches long) to an engineroom hatch cover to limit the opening of the cover. The wire rope is connected by bolts to the hatch cover and adjacent deck. No ripout is required to accomplish the work.

b. A shipyard experienced in naval nuclear submarine work has estimated that this work can be accomplished in a submarine in less than two hours.

c. Since this work can be performed in the OHIO (SSBN 726) during the next several months before sea trials without affecting the dockside test program, NAVSEA concludes there is no basis for this work causing any delay in the OHIO (SSBN 726).

3. NAVSEA Action:

a. Electric Boat is requested to re-evaluate its position with regard to accomplishments of the work required by Engineering Notice 6305, Rev. A. If Electric Boat still concludes that this work cannot be accomplished without delay of the OHIO (SSBN 726), Electric Boat should provide NAVSEA a detailed explanation of how installation of a wire rope to secure a hatch cover would delay the OHIO (SSBN 726).

b. As in the past, NAVSEA desires to be informed in advance of the contractual implications of proposed technical actions, so that these can be considered in deciding whether or not to authorize the work. In this regard, Electric Boat has indicated its willingness to cooperate. Therefore, the General Manager of Electric Boat is requested to ensure that Electric Boat's statements concerning ship delay in connection with potential contract changes are properly reviewed and valid.

4. The action taken by this letter is considered by NAVSEA to be within the scope of contract N00024-75-C-2014 and no change in contract delivery or completion date or in the current negotiated price or amount of any Government contract is authorized.

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
SUPSHIP, Groton
NRRO, Groton

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

15 July 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj.: Cancellation of Plans to Accomplish Reactor Modifications in ARKANSAS (CGN 41)

Encl: (1) NAVSEA letter Ser 081-1571 dated 15 July 1980

1. On 10 July 1980, I told you of a case in which authorization of reactor modifications in the nuclear powered cruiser ARKANSAS was being withheld because of a contractual problem at Newport News. Specifically, Newport News insisted on the right to claim contract adjustments for alleged impact on other contracts if the Navy authorized the reactor modifications in ARKANSAS. The Navy made repeated requests that Newport News identify any specific conflicts with other contracts so that the Navy might evaluate and resolve them, in advance. Newport News insisted that "impact of the work on other contracts may be determinable only after the work is well along". You said you would contact Tenneco officials.

2. On 11 July 1980, Newport News officials contacted the Navy, but again insisted that the Government recognize and provide for the payment of impact costs before the company would agree to accept a maximum price, bilateral contract modification to do the ARKANSAS repair job.

3. I consider Newport News' insistence on "impact" charges is an attempt to take contractual advantage of a technical problem. I doubt that Newport News charges commercial customers for "impact" on Navy ships. Nor am I aware of any situation where Government contracts have been credited with amounts collected from commercial contracts for such "impact".

4. Extensive technical analysis and testing indicates that the reactor modifications, although desirable, are not essential to the safe operation of the nuclear propulsion plant. Authorizing the modifications, in light of the terms insisted upon by Newport News, would set an unacceptable precedent wherein changes on one Government contract entitle a contractor to adjustments on other contracts; a concept long desired by claims lawyers and opposed by the Navy. Rather than expose the Navy in this manner, I have decided not to authorize the reactor modifications in ARKANSAS and by enclosure (1) have so informed the Supervisor of Shipbuilding.

5. Last night, the ARKANSAS achieved criticality in the Number 2 reactor plant. Thus, the opportunity to accomplish the reactor modifications as originally intended has now passed.

6. This episode highlights an increasing tendency at Newport News, as well as at Electric Boat, to dictate contract terms to the Navy and to have their contracts written and administered on an open-ended basis which provides ample opportunity for future claims.

H G Rickover
H. G. RICKOVER

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander, Naval Sea Systems
  Command (Contracts)
SUPSHIP, Newport News
NRRO, Newport News

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON D C 20362

IN REPLY REFER TO

Ser 08I-1571
15 July 1980

From: Commander, Naval Sea Systems Command
To: Supervisor of Shipbuilding, Conversion and Repair, USN, Newport News (5)

Subj: CGN41 (ARKANSAS) Reactor Modifications; Headquarters Modification Requisitions (HMRs) 366, 367, and 368; Cancellation of

Ref: (a) CGN41 Headquarters Modification Requisition (HMR) Number 366, forwarded by NAVSEA letter 08I-C1576 dated 6 June 1980
(b) CGN41 HMR 367 forwarded by NAVSEA letter 08I-C1574 dated 6 June 1980
(c) CGN41 HMR 368 forwarded by NAVSEA letter 08I-C1575 dated 6 June 1980
(d) Newport News letter 601/1-4-2087 dated 20 June 1980
(e) Newport News letter 601/1-4-2087 dated 26 June 1980

1. References (a) through (c) authorized certain preparatory work required to be accomplished if reactor modifications in ARKANSAS were to be authorized. The purpose of this letter is to cancel references (a) through (c).

2. In references (d) and (e), and in subsequent discussions between senior Navy and Newport News officials, Newport News has insisted on the right to claim contract adjustments for alleged impact on other contracts if the Navy authorizes the reactor modifications in ARKANSAS. The Navy made repeated requests that Newport News identify any specific conflicts with other contracts so that the Navy might evaluate and resolve them, in advance. Newport News has insisted that "impact of the work on other contracts may be determinable only after the work is well along".

3. NAVSEA considers Newport News' insistence on "impact" charges is an attempt to take contractual advantage of a technical problem. I doubt that Newport News charges commercial customers for "impact" on Navy ships. Nor am I aware of any situation where Government contracts have been credited with amounts collected from commercial contracts for such "impact".

4. Extensive technical analysis and testing indicates that the reactor modifications, although desirable, are not essential to the safe operation of the nuclear propulsion plant. Authorizing the modifications, in light of the terms insisted upon by Newport News, would set an unacceptable precedent wherein changes on one Government contract entitle a contractor to adjustments on other contracts; a concept long desired by claims lawyers and opposed by the Navy. Rather than expose the Navy in this manner, I have decided not to authorize the reactor modifications in ARKANSAS.

5. The Supervisor of Shipbuilding is requested to take appropriate action to discontinue all shipbuilder effort authorized to be performed by contract modifications which implemented references (a) through (c). The Supervisor should take similar action with respect to any contract modifications issued by Field Modification Requisitions in connection with preparations for accomplishment of the reactor modifications in ARKANSAS. Instructions will be provided by the applicable reactor plant prime contractor for shipping of the seal weld cutting machine and mock-ups furnished by the Government in connection with reference (b).

H. G. Rickover
H. G. RICKOVER
Deputy Commander for
Nuclear Propulsion

Copy to:
Secretary of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander, Naval Sea Systems Command (Contracts)
SUPSHIP, Newport News (5)
NRRO, Newport News

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D C 20362

IN REPLY REFER TO

15 July 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Adverse Impact on Nuclear Submarine Manning Resulting from Delays in Nuclear Submarine Work at Electric Boat Division of General Dynamics Corporation

Ref: (a) NAVSEA (08) Memorandum to SECNAV dtd 24 June 1980; Subj: Nuclear Submarine Work at the Electric Boat Division of General Dynamics Corporation

(b) CNO ltr ser 291/307790 dtd 16 Oct 1979; Subj: Nuclear Submarine Manpower Requirements Policy

1. In reference (a), I described several problems that are being experienced by the Navy in its efforts to get Electric Boat to satisfactorily complete work on nuclear powered submarines. I also noted in reference (a) that delays in construction of nuclear powered submarines at Electric Boat are causing serious Navy personnel problems that directly affect these new construction submarines and that indirectly affect submarines throughout the rest of the Navy.

2. The structural welding problem which was discovered in late December 1979 and the inability of Electric Boat to promulgate a schedule for completion of the work to correct this problem in each submarine involved has produced an unsatisfactory personnel manning situation in these submarines. It is essential that the adverse impact on nuclear trained personnel resulting from the delays in nuclear submarine work at Electric Boat be promptly addressed in conjunction with other actions necessary to obtain firm commitments for satisfactorily completing these submarines.

3. The Chief of Naval Operations promulgated the policy for new construction nuclear submarine manpower requirements in reference (b). Specifically, certain key officer and enlisted billets are manned based on the planned state of completion of the propulsion plant. This policy is essential in order to have the necessary nuclear trained personnel on board and properly trained to safely conduct testing in the nuclear propulsion plant. In addition, the initial group of personnel assigned to a new construction submarine are sea experienced. The use of sea experienced personnel helps assure the success and safety of the test programs. It also provides the necessary base of experience for operating the ship at sea during sea trials and after commissioning. For example, SSN new construction billet phasing policy provides for assignment of seven sea experienced officers and twenty-four sea experienced nuclear trained enlisted personnel three months prior to initial fill of the reactor plant systems.

4. If construction of a nuclear powered submarine follows the initial schedule reasonably well, the personnel situation is relatively stable, with some planned transfers and a few unplanned losses occurring that can be handled through normal procedures by the Chief of Naval Personnel. However, long delays in construction such as those which have been and are being experienced at Electric Boat cause excessive unplanned personnel turnover with a drastic net reduction in overall crew experience level. The failure of Electric Boat to establish a delivery date, even though a formal written request was made by the Naval Sea Systems Command on 22 May 1980, further complicates efforts to improve the unsatisfactory manning situation.

5. The excessive unplanned turnover of personnel during submarine construction causes many problems. Because of the overall shortage of experienced nuclear trained operators, in many cases it is necessary to replace the required sea experienced personnel with personnel who have just completed their initial nuclear training at the land based nuclear propulsion plant prototypes. In some instances drastic action is necessary to provide adequate experienced manning for safe initial at-sea testing of the nuclear propulsion plant. Usually this involves sudden transfer of experienced personnel from another ship, sometimes in a different homeport, to the new ship whose manning levels are deficient. In the long run this type of response results in lower morale and poorer retention and causes the Navy to incur added costs for additional recruiting and training. These experienced nuclear trained personnel, who have trained for months in the shipyard in anticipation of going to sea, leave the Navy before full use is ever made of them. In the case of recent prototype graduates who are assigned to a new construction ship as their first duty, although they gain experience in operating the propulsion plant in a shipyard environment, they do not gain the much needed experience of operating a ship, and particularly a submarine, at sea. As a result, these recent prototype graduates in a ship which is delayed may have one to two years on board with no sea experience.

6. The degradation of experience of nuclear trained enlisted personnel in BREMERTON (SSN 698) as a result of delays due to structural welding problems provides an unfortunate example of the impact significant delays in ship construction have on manning. BREMERTON was manned in April 1978 with 24 sea experienced nuclear enlisted operators. These sea experienced personnel were assigned three months prior to scheduled reactor plant fill as required by reference (b). The sea experienced nuclear trained personnel were assigned with sufficient obligated service and tour lengths to allow them to remain with the ship through scheduled reactor plant testing, sea trials, commissioning and the shakedown period or until about one year after commissioning. When BREMERTON was initially manned in April 1978, commissioning was scheduled for October 1979 and senior personnel assigned had sufficient obligated service to remain on board through April to December 1980. With the delays in

BREMERTON's schedule resulting in sea trials not being completed or even scheduled as of July 1980, senior enlisted nuclear trained personnel are being lost from BREMERTON either because they leave the Navy or because they reenlist for a guaranteed assignment to other duty. In June 1980, only 11 of 24 original sea experienced personnel remained on board.

7. The problems described in the case of BREMERTON are not unique and are developing in similar fashion in JACKSONVILLE (SSN 699) and DALLAS (SSN 700). The current projection of experienced personnel manning in these two ships show that in a few months their manning situation will be worse than that of BREMERTON. The personnel situation in follow-on SSN 688 Class ships at Electric Boat (SSN's 701, 702, 703, 704) will also be affected, but it is impossible to predict the impact since Electric Boat has not provided a schedule for correction of the welding problems in these ships. The SSN 705 should normally be manned commencing in November 1980, but according to the best information available to me, at least a two month delay is more realistic. The Navy does not have the manpower available to continue to assign experienced personnel to new construction submarines based on unrealistic schedules and then have them "sit around" in an unproductive manner while the shipyard resolves its construction problems at an unpredictable rate.

8. In summary, the Naval Sea Systems Command has not been able to obtain current, realistic schedules for submarines under construction at Electric Boat in order to permit the Chief of Naval Personnel to efficiently plan personnel assignments for these ships. In view of this situation, I believe it would be appropriate for you to raise this issue with the Chairman of the General Dynamics Corporation. It should be emphasized to General Dynamics management that:

a. The poor performance at its Electric Boat Division is seriously impacting the Navy's personnel problems, and

b. Current realistic schedules for submarines under construction are urgently required by the Navy.

9. I would appreciate being informed of the action you take in this matter.

H. G. Rickover
H. G. RICKOVER

Copy to:
Chief of Naval Operations
Chief of Naval Material
Chief of Naval Personnel
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
25 July 1980

From: Commander, Naval Sea Systems Command
To: Supervisor of Shipbuilding, Conversion and Repair, USN
Newport News

Subj: Use of Unilateral Change Orders

Ref: (a) SUPSHIP Newport News letter to ADM Rickover dated 11 July 1980

1. In reference (a) you informed me of your concern "that we are not taking advantage of the use of Change Orders to authorize new work." You based this concern on the premise that the time needed to obtain price proposals and adjudicate changes often adds delay and increases the cost of performing the changed work.

2. You cited as an example of your concern the 23 days of delay adjudicated for the repair and replacement of copper-nickel bosses in the Reactor Plant Fresh Water System on SAN FRANCISCO (SSN 711). You concluded that had an unpriced unilateral change order been issued on 1 November 1979 rather than the maximum priced supplemental agreement which was executed on 21 November 1979, the Navy could have "significantly reduced delay."

3. I do not agree with your conclusion. Work on the SAN FRANCISCO could not have begun on 1 November 1979 as you imply. The technical action to correct the problem was taken by NAVSEA on 15 November 1979. Further, additional technical evaluations led to replacement of two more copper-nickel bosses in SAN FRANCISCO. The technical action to replace the additional bosses and the contractual authorization were both taken by NAVSEA on 3 January 1980. Based on NAVSEA's review of the progress reports furnished by your office, it was the replacement of these two additional bosses, authorized over one month after the original change, that caused the 23 day delay finally negotiated for SAN FRANCISCO.

4. You stated your belief that authorizing the ARKANSAS (CGN 41) noise modification by unilateral change order would not have increased the Navy's ultimate liability. While it may be possible for you to monitor the work actually performed and establish a reasonable estimate of cost for negotiating a final settlement, nothing requires the shipbuilder to agree. The "impact" charges alleged by Newport News for the ARKANSAS work are an example of how authorizing work unilaterally would have opened a new area for Newport News to submit claims, and which might involve prolonged litigation.

5. As you are aware, although desirable, the ARKANSAS noise modification is not essential to the safe operation of the nuclear propulsion plant. As stated in my memorandum for the Secretary of the Navy on the subject, authorizing the modifications based on the terms and conditions dictated by Newport News including "impact" charges, would set an unacceptable precedent wherein changes on one Government contract would entitle a contractor to adjustments on other contracts; a concept long desired by claims lawyers and opposed by the Navy.

6. I do not agree that we should use unpriced unilateral change orders more frequently. I have always found it best, whenever possible, to limit the Government's financial liability in advance of authorizing changes. In addition, the procurement regulations provide that for contract changes:

> "... either a final price or an established ceiling price shall be negotiated prior to execution, unless to do so would be patently impractical."

7. For my work I will continue to request fully-priced or maximum-priced proposals for changes prior to authorization of those changes except in instances where the work must be done and it is impossible to obtain such proposals.

H. G. Rickover

H. G. Rickover

Copy to:
Commander, Naval Sea Systems Command
Deputy Commander, Naval Sea Systems
  Command (Contracts)
NRRO, Newport News

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

27 August 1980

MEMORANDUM FOR THE GENERAL COUNSEL OF THE NAVY
COMPTROLLER OF THE NAVY

Subj: Deferred payment agreements with Electric Boat Division in connection with Armed Services Board of Contract Appeals Case No. 21737 regarding cost disallowance under "Basic Agreement Concerning Overhead Costs"

1. Because of increased Navy concern with regard to high overhead costs at Electric Boat during the early 1970's, the Naval Sea Systems Command and the shipbuilder entered into the "Basic Agreement Concerning Overhead Costs" in August 1972. The Agreement formed a part of each Atomic Energy Commission (now Department of Energy) contract and subcontract for Naval nuclear propulsion work and each Navy contract and subcontract existing or subsequently awarded to Electric Boat with respect to overhead costs incurred during the period 1 January 1972 through 31 December 1975. The Agreement provided that if otherwise allowable overhead costs exceeded stated annual maximum amounts for 1972-1975, after making certain adjustments permitted by the Agreement, the costs would be disallowed under the applicable contracts.

2. In 1977, the Navy issued final Contracting Officer decisions which, in accordance with the terms of the Overhead Agreement, disallowed approximately $63 million in overhead costs for the years 1973-1975 on Navy contracts. The Contracting Officer also determined that the Navy had by then made provisional payments to Electric Boat for unallowable overhead costs and demanded repayment of over $27.9 million. Electric Boat appealed these decisions to the Armed Services Board of Contract Appeals (ASBCA) and requested that the Navy enter into deferred payment agreements pursuant to the provisions of the Defense Contract Financing Regulations contained in Appendix E of the Armed Services Procurement Regulation (now Defense Acquisition Regulation). The deferred payment agreements would allow Electric Boat to delay the repayments to the Government pending the outcome of the appeals.

3. At the time Electric Boat requested the deferred payment agreements in 1977, the company was experiencing severe financial difficulties as a result of cost overruns on the SSN 688 Class construction program. The company alleged "unreimbursed expenditures" in excess of $200 million. Based on Electric Boat's cash flow situation at that time, the Naval Sea Systems Command recommended that the Comptroller of the Navy grant the shipbuilder's request for the deferred payment agreements. Under the deferred payment agreements entered into during 1977, the Navy agreed not to recoup

the $27.9 million in overpayments pending resolution of the contractor's appeal. By 1978, the cash flow problem which arose from the company's cost overrun on SSN 688 Class contracts was alleviated by the 1978 P.L. 85-804 settlement. Under the terms of that settlement, Electric Boat agreed to write off a $359 million loss ($187 million after taxes), and received a $300 million cash payment from the Navy.

4. With the deferred payment agreements, Electric Boat has a strong incentive to delay or avoid resolution of the overhead cost dispute. The company holds $27.9 million which the Contracting Officer had determined to be the overpayment when he issued his final decisions. Unless the ASBCA rules 100 percent for Electric Boat, the company will owe the Navy a refund.

5. It is apparent that Electric Boat is trying to stretch out litigation of this case, which I understand is the largest case presently before the ASBCA. Repeated efforts by the Office of Navy General Counsel in establishing and maintaining a firm schedule for litigation have been unsuccessful. The case has already been in litigation for over three and one-half years, during which time there have been numerous requests for documents and several rounds of interrogatories. Counsel for Electric Boat (Sellers, Conner & Cuneo) has repeatedly delayed pre-trial activities. Deposition proceedings have finally started but the attorneys for Electric Boat recently notified the Navy that the depositions of three General Dynamics officials would have to be delayed from mid-August to mid-September. This jeopardizes the 15 October 1980 trial date Sellers, Conner & Cuneo recommended to the ASBCA on 13 February 1980. An Electric Boat official commented recently that he doubted the case would come to trial before the first of next year.

6. Meanwhile, Electric Boat has been trying to obtain other deferred payment agreements to cover approximately $4.5 million of overhead costs disallowed in accordance with the terms of the Overhead Agreement under Electric Boat subcontracts performed under Department of Energy and Navy prime contracts with General Electric. In response to the refusal of the General Electric Company and the Government to enter into any such deferred payment agreements, Electric Boat recently filed an appeal before the Department of Energy Board of Contract Appeals concerning the continued withholding of funds by General Electric under the Department of Energy prime contract.

7. At the rate they are going, Electric Boat and Sellers, Conner & Cuneo could probably drag out the ASBCA appeal for several more years. This would work to the substantial advantage of Electric Boat. As time passes memories tend to fade, people become more difficult to locate and the matter becomes even more difficult to settle on its merits. It is therefore essential that the Navy take whatever steps are available to preclude any further unnecessary delays.

8. The provisions of the Defense Acquisition Regulation and the Navy's deferred payment agreements with Electric Boat provide that the Navy may terminate the agreements and demand repayment upon failure of the contractor to pursue diligently the resolution of its appeal. The record of the past three and one-half years and the delaying actions the company continues to employ make it clear that Electric Boat has not fulfilled its obligations to resolve the dispute in a diligent manner. The Navy, on the other hand, is committed to Congress to resolve contracting disputes promptly on their merits. It will not speak well for Navy management if it cannot preclude a contractor who is enjoying the benefits of a deferred payment agreement from unduly delaying resolution of a dispute before the ASBCA. Therefore, I recommend that the Navy establish with the company a firm schedule, built around the 15 October 1980 trial date previously recommended by Electric Boat for resolution of this dispute before the ASBCA. If the company fails to cooperate in this effort or upon the company's failure to adhere to the schedule, the Navy should immediately rescind the deferred payment agreements and recover the disallowed amounts as an offset to future progress payments due Electric Boat.

9. I would appreciate being informed of the action you take with respect to the above.

H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
  Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

6 September 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Electric Boat refusal to honor its agreement with the Navy for repairs of government furnished equipment

Encl: (1) Memorandum of Agreement dated 15 January 1979
(2) My letter to Mr. Lewis dated 18 August 1980
(3) Letter to Me from Mr. Lewis dated 21 August 1980

1. In the aftermath of the PL 85-804 settlement of the Electric Boat SSN 688 Class contract claims, the Navy set out to strengthen procedures to ensure that its contracts would be administered on a pay-as-you-go basis. In this regard, the then Vice Commander of the Naval Sea Systems Command, Rear Admiral Manganaro, was designated as the Navy's representative to resolve with senior Electric Boat management several major problems involved with administration of Electric Boat submarine construction contracts.

2. The first problem addressed in this effort involved Electric Boat efforts to establish repairs to Government furnished equipment (GFE) as a basis for subsequent claims. Specifically, after many years of receiving authorization and payment for repairs to nuclear GFE directly from reactor plant prime contractors under cost reimbursement contracts, Electric Boat announced that it would not accept further authorizations under this arrangement without reserving the right to submit later claims for alleged delay and disruption. This violated the Navy's policy of fully pricing contract work prior to authorization and undermined a longstanding and effective system for paying for such repairs promptly without exposing the Government to after-the-fact claims.

3. After many months of discussions and negotiations, Mr. Veliotis, General Manager of Electric Boat, signed an agreement with the Navy in which he agreed to handle repairs of nuclear GFE in accordance with past practice. In this regard, the agreement states the following:

> "Repairs or modifications to nuclear GFE which Electric Boat agrees do not involve ship delay or disruption or a change to any Government contract shall be done under a Work Authorization issued on a cost-type contract administered and funded for this purpose by Naval Nuclear Propulsion Program prime contractors."

Enclosure (1) is a copy of the full agreement.

4. Subsequent to the agreement, the work authorization circuit again ran smoothly, providing a convenient vehicle in cases not involving ship delay for authorizing and paying for repairs to nuclear GFE in a way that would not leave the Government open for subsequent claims. Recently, however, Electric Boat reneged on the agreement by refusing to renew the Knolls Atomic Power Laboratory's (KAPL) cost type contracts used to authorize and pay for these repairs. The company is now insisting that these repairs be authorized as changes to the shipbuilding contract itself. In this way, the company would have a basis to reopen routine GFE repairs as a basis for subsequent claims. The pertinent facts are as follows:

a. The KAPL cost-type GFE repair contracts were scheduled to expire June 30, 1980; they were extended until July 31, 1980 to provide additional time for negotiations.

b. In its proposal to renew these contracts, Electric Boat decided to demand a higher fee than the 7 percent figure which, by prior understanding, was traditionally accepted for this type work.

c. During negotiations Electric Boat reduced the requested fee from 8.5 percent to 8.1 percent while KAPL increased its offer from 7 percent to 7.5 percent.

d. When efforts to get Electric Boat management to accept the 7.5 percent fee failed, I called the President of General Dynamics, Mr. Boileau, and requested his assistance.

e. Mr. Boileau agreed to extend the existing contracts another month so that repairs to GFE could continue while he was looking into the matter.

f. KAPL, when notified of Mr. Boileau's agreement, contacted Electric Boat to arrange for the extension he had agreed to. The Electric Boat people insisted that the contracts would be extended only if the Navy agreed to the Electric Boat position on fee — 8.1 percent.

g. The General Manager of KAPL then raised the issue with Mr. Veliotis, the General Manager of Electric Boat, and offered to accept the 8.1 percent fee Electric Boat was demanding. Mr. Veliotis told him that Electric Boat would no longer contract with KAPL for this work — even at the 8.1 percent fee.

h. Since Mr. Boileau apparently had no influence over the Electric Boat Division of the corporation, I wrote to the Chairman of the Board and Chief Executive Officer of General Dynamics, Mr. David Lewis, on 18 August 1980 explaining the problem and requesting his assistance. Enclosure (2) is a copy of my letter. I told him that it was inconceivable to me that extension of cost-type contracts which were apparently acceptable to Electric Boat on 31 July 1980 could become unacceptable to the company five days later.

i. Mr. Lewis responded on 21 August 1980. Enclosure (3) is a copy of his response. He said he agreed with Mr. Veliotis' position not to accept the follow-on cost-type GFE repair contracts and that future repairs to Government furnished equipment should be authorized under the shipbuilding contracts. He stated "... it has been Electric Boat's experience that large numbers of GFE repair items can collectively cause delay and disruption even though each identified item, viewed alone, would hardly justify a program delay and disruption contract price increase."

5. There is considerably more at stake in this matter than fee levels on cost type contracts. The company is again trying to reestablish GFE repairs as a basis for future after-the-fact claims, and in the process has violated its agreement with the Navy.

6. This is not an isolated instance. As you well know, throughout the TRIDENT and SSN 688 contract negotiations Electric Boat has maneuvered to create in the contract itself bases for subsequent claims. Examples are:

a. Electric Boat's continued demands for a loophole whereby the company could evade the semi-annual claims releases called for by Notification of Changes clause simply by attributing claims to events arising on other contracts.

b. Electric Boat's refusal to provide claims releases on the new contracts for events occurring prior to award of the new contracts.

c. Electric Boat's recent demand that continued performance of the contract in the event the company alleges a breach of contract is contingent on Government payment of all costs incurred from that point on, without regard to contract price.

7. I believe the substantial delays and other problems being experienced at Electric Boat will result in cost overruns on current contracts far greater than those the company currently reports. No doubt this accounts for Electric Boat's intensive efforts to lay the basis for future claims. On the other hand, I understand the NAVSEA Deputy Commander for Contracts has made it clear to Electric Boat that NAVSEA will not enter into any new contracts which leave the Government vulnerable to large claims submitted years after the fact and that the company must also

commit contractually to a program for upgrading quality assurance in view of the substantial quality problem being experienced at the yard.

8. The GFE agreement was worked out at the highest levels of Electric Boat and the Naval Sea Systems Command as part of the Navy's claims prevention effort. By reneging on the agreement, Electric Boat has set the Navy back in one of the few areas in which it appeared that some progress was made in claims prevention. In view of the Navy's commitment to Congress to administer contracts on a pay-as-you-go basis I recommend that the Naval Sea Systems Command insist that Electric Boat honor its agreement with respect to repairs of Government furnished equipment as a prerequisite to award of the TRIDENT and SSN 688 Class submarines now being negotiated.

9. I would appreciate being informed of the action you take on this item.

H. G. Rickover

H. G. Rickover

Copy to:

Chief of Naval Material
Vice Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
  Naval Sea Systems Command

5 January 1979

MEMORANDUM OF AGREEMENT

The purpose of this memorandum is to establish the procedure for the contractual authorization of repairs and modifications to Government-Furnished Equipment (GFE) provided under the submarine construction contracts with Electric Boat. In repairs or modifications to Government-Furnished Equipment, time is sometimes of the essence in the authorization to start the work because of the impact this work may have on other work and on ship schedules. It is the intent of the parties to provide for timely authorization, pricing, and definitization of work on Government-Furnished Equipment, and to provide the Government the ability to assess the financial and contractual implications of the proposed repairs or modifications prior to authorizing them or deciding on alternative courses of action where possible.

A. Modification and repair to nuclear GFE with no disruption or delay in ship delivery.

1. Repairs or modifications to nuclear GFE which Electric Boat agrees do not involve ship delay or disruption or a change to any Government contract shall be done under a Work Authorization issued on a cost-type contract administered and funded for this purpose by Naval Nuclear Propulsion Program prime contractors.

2. Upon Electric Boat acceptance of a Work Authorization, Electric Boat will sign the GFE deficiency report stating that no delay in ship delivery will result and that no change in the current negotiated price or amount of any contract is required as a result of the work covered by the Work Authorization. SUPSHIP will then sign the Electric Boat GFE deficiency report which identifies the Work Authorization funding and which will be the authority for diversion of material and for performing work in accordance with the Work Authorization.

B. Repairs or modifications of nuclear and non-nuclear GFE involving less than $10,000 in hard core work and not involving ship delivery delay.

Repairs or modifications to GFE which do not involve delay in ship delivery or change to any other Government contract and which cannot be handled under the Naval Nuclear Propulsion Program Work Authorization described above (e.g., Nuclear GFE where work under the shipbuilding contract would be impacted or non-nuclear (GFE) will be handled as follows:

1. Repairs or modifications in this category will be done under a forward pricing agreement similar to the previous arrangement under FMR 14.1 under Contract N00024-71-C-0268. Upon notification by Electric Boat that a repair or modification is accepted in this category, SUPSHIP will authorize the work.

1[illegible] January 1979

2. Electric Boat will submit a proposal for the forward pricing agreement described above within 60 days. The parties will make best efforts to negotiate and definitize that proposal within 30 days of receipt.

C. Repairs or modifications to nuclear and non-nuclear GFE other than those covered by A or B above.

1. Electric Boat will submit to SUPSHIP a fully priced proposal for the work when Electric Boat agrees the scope of work is sufficiently defined to permit fixed pricing and schedule evaluation.

2. If it is impractical to submit a fully priced proposal before the date authorization is required, Electric Boat will submit a maximum priced proposal, including proposed impact on ship contract delivery date, prior to authorization by SUPSHIP.

3. When Electric Boat cannot provide either a fully priced or maximum priced proposal prior to the date authorization is required, the Government will authorize the repairs or modifications unilaterally or will notify Electric Boat of the Government's disposition of the deficiency. In the event the Government authorizes the repairs or modifications unilaterally, Electric Boat will provide a fully priced proposal for the work in accordance with the articles of the contract entitled "Government Furnished Property" and "Changes".

Approved:

P. T. Veliotis
General Manager
Electric Boat Division
General Dynamics

W. L. MARTIN III, CAPT., USN
Supervisor of Shipbuilding
Conversion and Repair, USN
Groton, Connecticut

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

18 August 1980

Mr. David S. Lewis
Chairman of the Board
General Dynamics Corporation
Pierre Leclede Center
St. Louis, Missouri 63105

Dear Mr. Lewis:

The purpose of this letter is to request your assistance in resolving a current problem at Electric Boat Division of General Dynamics.

It has been a longstanding practice of the Naval Nuclear Propulsion Program to handle the repair of reactor plant Government furnished equipment (GFE) through work authorizations issued under cost-type contracts administered by the reactor plant prime contractors. A memorandum of agreement (attached) outlining this procedure at Electric Boat was signed on 15 January 1979, by the General Manager of Electric Boat, Mr. Veliotis, and the Supervisor of Shipbuilding. This procedure provides a rapid and equitable means of obtaining repairs or modifications to GFE and has worked well over the years at all yards involved in Navy nuclear ship construction or repair.

Because the contracts for this work at Electric Boat were scheduled to expire on 30 June 1980, the cognizant prime contractor, the Knolls Atomic Power Laboratory (KAPL), requested Electric Boat to provide a proposal for follow-on contracts. Electric Boat's proposal included a higher fee than had previously been paid for this work. To provide more time for negotiations, the contracts were subsequently extended to 31 July 1980. Negotiations reached an impasse with Electric Boat requesting 8.1% fee and KAPL offering 7.5%. (The fee for this work on the earlier contracts had been 7.0%.)

I requested assistance from the President of General Dynamics (Mr. Boileau) to get the contracts awarded. Mr. Boileau assured me that the existing contracts could be extended for another 30 days while the fee issue was being negotiated. Nonetheless, when KAPL tried to extend the existing contracts with the current 7% fee, Electric Boat refused, stating that the contracts could only be extended if agreement was reached for the fee for the follow-on contracts. On 5 August 1980 KAPL offered to extend existing contracts with the 8.1% fee as requested by Electric Boat. Electric Boat, however, again refused to accept the extension stating that it no longer intended to contract with KAPL for this work.

It is inconceivable to me that extension of cost-type contracts which were apparently acceptable to Electric Boat on 31 July 1980 could become unacceptable to the company five days later. Apparently Mr. Veliotis is using these small but important contracts to "prove" to the Navy and to his superior, Mr. Boileau, that he alone can make decisions affecting work at Electric Boat -- even if, to make his point, he reneges on a formal commitment he previously entered into with the Navy. It appears that Mr. Boileau as President of the corporation has little control or influence over senior management at Electric Boat. Accordingly, I request your assistance, as Chairman of the Board, in getting Electric Boat to accept the KAPL contracts for repair of Government furnished reactor plant equipment.

Sincerely,

H. G. Rickover

H. G. Rickover

Attachment

I would appreciate hearing from you at your earliest convenience. The existing situation harbors no good for the Navy, or for General Dynamics
—Rickover

15 January 1979

MEMORANDUM OF AGREEMENT

The purpose of this memorandum is to establish the procedure for the contractual authorization of repairs and modifications to Government-Furnished Equipment (GFE) provided under the submarine construction contracts with Electric Boat. In repairs or modifications to Government-Furnished Equipment, time is sometimes of the essence in the authorization to start the work because of the impact this work may have on other work and on-ship schedules. It is the intent of the parties to provide for timely authorization, pricing, and definitization of work on Government-Furnished Equipment, and to provide the Government the ability to assess the financial and contractual implications of the proposed repairs or modifications prior to authorizing them or deciding on alternative courses of action where possible.

A. Modification and repair to nuclear GFE with no disruption or delay in ship delivery.

1. Repairs or modifications to nuclear GFE which Electric Boat agrees do not involve ship delay or disruption or a change to any Government contract shall be done under a Work Authorization issued on a cost-type contract administered and funded for this purpose by Naval Nuclear Propulsion Program prime contractors.

2. Upon Electric Boat acceptance of a Work Authorization, Electric Boat will sign the GFE deficiency report stating that no delay in ship delivery will result and that no change in the current negotiated price or amount of any contract is required as a result of the work covered by the Work Authorization. SUPSHIP will then sign the Electric Boat GFE deficiency report which identifies the Work Authorization funding and which will be the authority for diversion of material and for performing work in accordance with the Work Authorization.

B. Repairs or modifications of nuclear and non-nuclear GFE involving less than $10,000 in hard core work and not involving ship delivery delay.

Repairs or modifications to GFE which do not involve delay in ship delivery or change to any other Government contract and which cannot be handled under the Naval Nuclear Propulsion Program Work Authorization described above (e.g., Nuclear GFE where work under the shipbuilding contract would be impacted or non-nuclear (GFE) will be handled as follows:

1. Repairs or modifications in this category will be done under a forward pricing agreement similar to the previous arrangement under FMR 14.1 under Contract N00024-71-C-0268. Upon notification by Electric Boat that a repair or modification is accepted in this category, SUPSHIP will authorize the work.

2. Electric Boat will submit a proposal for the forward pricing agreement described above within 60 days. The parties will make best efforts to negotiate and definitize that proposal within 30 days of receipt.

C. Repairs or modifications to nuclear and non-nuclear GFE other than those covered by A or B above.

1. Electric Boat will submit to SUPSHIP a fully priced proposal for the work when Electric Boat agrees the scope of work is sufficiently defined to permit fixed pricing and schedule evaluation.

2. If it is impractical to submit a fully priced proposal before the date authorization is required, Electric Boat will submit a maximum priced proposal, including proposed impact on ship contract delivery date, prior to authorization by SUPSHIP.

3. When Electric Boat cannot provide either a fully priced or maximum priced proposal prior to the date authorization is required, the Government will authorize the repairs or modifications unilaterally or will notify Electric Boat of the Government's disposition of the deficiency. In the event the Government authorizes the repairs or modifications unilaterally, Electric Boat will provide a fully priced proposal for the work in accordance with the articles of the contract entitled "Government Furnished Property" and "Changes".

Approved:

P. T. Veliotis
General Manager
Electric Boat Division
General Dynamics

W. L. MARTIN III, CAPT., USN
Supervisor of Shipbuilding
Conversion and Repair, USN
Groton, Connecticut

GENERAL DYNAMICS CORPORATION
Pierre Laclede Center
St. Louis Missouri 63105

David S. Lewis
Chairman and Chief Executive Officer

314-862-2440

21 August 1980

Admiral H. G. Rickover
Naval Sea Systems Command
Department of the Navy
Washington, D.C. 20362

Dear Admiral Rickover,

In response to your letter of 18 August 1980, I have reviewed the events surrounding the negotiations of the extension of the Memorandum of Agreement between General Dynamics and the Navy for the repair of the reactor plant GFE. While the present contract as extended expired on 31 July 1980, I have been advised that there has been no interruption of work on this GFE nor was any interruption contemplated or threatened, therefore, required work is, in fact, being accomplished.

Your letter is particularly concerned with the earnings rates proposed for the extension of the previous Memorandum of Agreement. However, over the past few weeks, Electric Boat management reviewed the work done previously under the agreement to determine whether this type of contractual arrangement was indeed appropriate or necessary. This review concluded that the standard government furnished property clause of the basic shipbuilding contract provides an appropriate contractual vehicle for repair of government furnished property. This standard clause is in the majority of the Government contracts which General Dynamics has with the Navy, Air Force and Army and our experience has been that GFE repairs are handled under this standard contract clause in a straightforward and timely manner.

We recognize the vital importance of timely repair of GFE and we see no reason why the use of a standard GFE repair clause would occasion any more delay than would result from the use of the KAPL type contract arrangement. In addition, the use of the standard contract clause provides protection for the contractor against delay and disruption of the overall program if it occurs as a result of the need to repair GFE. I recognize that the previous Memorandum of Agreement covering KAPL GFE is designed for use where no delays or disruptions in ship delivery are anticipated. However, it has been Electric Boat's experience that large numbers of GFE repair items can collectively cause delay and disruption even though each individual item, viewed alone, would hardly justify a program delay and disruption contract price increase. This situation is in no way

Enclosure (3)

unique to the submarine programs and the use of the standard government furnished property clause has resulted in GFE repairs being made on an efficient and timely basis, when the two parties are determined to make the contract provisions work.

The General Manager of Electric Boat believes that this entire process can be better handled in a standard contractual manner and for that reason he proposed that the January 1979 Memorandum of Agreement not be extended further. I agree with this position. Accordingly, I recommend that the Supervisor of Shipbuilding and the General Manager of Electric Boat set up procedures to implement the provisions of the standard government furnished property clause in the existing shipbuilding contracts to cover necessary repair work on reactor plant GFE as well as on other GFE.

Sincerely,

GENERAL DYNAMICS CORPORATION

D. S. Lewis
David S. Lewis
Chairman

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

11 September 1980

MEMORANDUM FOR DEPUTY COMMANDER FOR NUCLEAR PROPULSION (SEA 08)

Subj: Government Furnished Equipment (GFE) Repairs at Electric Boat

Ref: (a) SEA 08 memo to SEA 00 of 6 September 1980

1. Reference (a) provided information on problems being experienced with Electric Boat concerning pricing repairs to nuclear GFE for the TRIDENT and SSN 688 Class programs. You recommended that as a prerequisite to award of the TRIDENT and SSN 688 Class submarine contract now under negotiation, NAVSEA should insist Electric Boat agree to conform to the January 1979 Electric Boat/SUPSHIP agreement on handling pricing of GFE repairs.

2. I agree that we should have a means of authorizing GFE repairs so that contracts can be administered on a current, pay-as-you-go basis. While we can pursue arrangements with Electric Boat for generally pre-pricing GFE repairs under the shipbuilding contract, I consider we have little leverage to require that Electric Boat deal with a Nuclear Propulsion Plant Component prime contractor even though this had been a long standing practice. Nevertheless, the GFE repair problem should be addressed in the current negotiations. I have directed Captain Platt to include in TRIDENT and SSN 688 Class negotiations discussions directed at either reactivating the January 1979 Memorandum of Agreement or some mutually agreeable alternative means to price GFE repairs.

Very respectfully,

E. B. Fowler

E. B. FOWLER

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

24 September 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Government furnished equipment (GFE) repairs at Electric Boat

Ref: (a) My memo to you dated 6 September 1980
(b) Your memo to me dated 11 September 1980

1. In reference (a) I pointed out how Electric Boat had reneged on an agreement entered into with the Navy in which the Navy and Electric Boat formalized procedures to handle repairs to Government furnished equipment (GFE). The agreement contained a section which called for nuclear GFE to be repaired in accordance with past practice. I recommended that, as a prerequisite to the award of the TRIDENT and SSN 688 Class submarine contracts now under negotiation, NAVSEA should insist that Electric Boat agree to conform to that January 1979 agreement.

2. Repairs to GFE at Electric Boat was just one of several contract administration problems that arose on the heels of the PL 85-804 claims settlement in 1978 and which indicated that the company was trying to set up the Navy for future claims. These problems were the subject of a meeting with the Chairman of the Board of General Dynamics; the General Manager, Electric Boat; the Secretary of the Navy; the Chief of Naval Material, and other senior Navy officials. Subsequently, the then Vice Commander of the Naval Sea Systems Command, RADM Manganaro, was assigned the lead to resolve these problems. Of the three issues to be addressed at that time, only one – repairs to GFE – was settled. The January 1979 Memorandum of Agreement was arrived at only after months of work by RADM Manganaro and others.

3. You stated in reference (b) that you had directed the Deputy Commander for Contracts, Captain Platt, to include in the current TRIDENT and SSN 688 Class construction contract negotiations "discussions directed at either reactivating the January 1979 Memorandum of Agreement or some mutually agreeable alternative means to price GFE repairs." You further stated, "While we can pursue arrangements with Electric Boat for generally pre-pricing GFE repairs under the shipbuilding contract, I consider we have little leverage to require that Electric Boat deal with a Nuclear Propulsion Plant component prime contractor even though this had been a long standing practice."

4. The issue of Electric Boat's renege of the 1979 agreement concerning repairs to GFE should be considered in the context of our overall problems with Electric Boat and the Navy's commitment to Congress to keep contracts current and administered on a pay-as-you-go basis. Moreover, the 1979 agreement involved more than just the provision requiring acceptance of contracts from Naval Nuclear prime contractors. It also provided for the pre-pricing of repairs to non-nuclear GFE under the shipbuilding contracts. If the company can unilaterally void one part of the 1979 Memorandum of Agreement it can void other parts. Therefore, I recommend that NAVSEA pursue this issue from the standpoint of getting Electric Boat to honor its agreement rather than reopening negotiations with Electric Boat for alternative means of handling GFE repairs.

5. I do not agree with the reference (b) comment that "we have little leverage" to require Electric Boat to live up to the terms of the 1979 agreement. The terms of the contracts being negotiated, as well as those of the existing Electric Boat contracts, clearly provide that the Contractor will obtain from third parties compensation for repairs to GFE. The 1979 agreement merely provided the detailed mechanism for meeting this contract requirement.

6. Based on the above, I urge that the Naval Sea Systems Command insist that Electric Boat honor the 1979 agreement on the repair of GFE as a prerequisite to the award of the FY 1980/81 submarines. If the company continues to refuse to honor the agreement, then the matter should be escalated to the level of the Chief of Naval Material and the Secretary of the Navy as indicative of the problems in dealing with Electric Boat. I would appreciate being kept informed of NAVSEA's action on this matter.

H. G. Rickover

H. G. Rickover

Copy to:
Vice Commander, Naval Sea
  Systems Command
Deputy Commander for Contracts,
  Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
24 September 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Construction of Nuclear Submarines in Navy Shipyards

Ref: (a) NAVSEA Ltr PMS 393/MG Ser 2099 dtd 19 Sept 1980

1. Public Law 89-37 reinstated the Vinson-Trammell Act requirement regarding construction of warships and escort vessels "that the first and each succeeding alternate vessel shall be constructed in the Government Navy yards: Provided, That, if inconsistent with the public interests in any year to have a vessel or vessels constructed as required above, the President may have such vessel or vessels built in a Government or private yard as he may direct." In the past the Navy has requested, and received, a Presidential determination that it is in the public interest to build all warships in private shipyards.

2. I recently received for concurrence the Navy's request for Presidential authorization to construct all of the Fiscal Year 1981 warships in private shipyards. The requested authorization would include the Fiscal Year 1981 SSN 688 Class and TRIDENT Class submarines.

3. In reference (a) NAVSEA requested the Commanders of three Navy shipyards to "make an appraisal of actions required to undertake construction of follow-on SSN 688 Class and Fleet Attack Submarines." Reestablishing a nuclear submarine construction capability at Navy shipyards would allow construction of the Fiscal Year 1981 ships to begin while current problems at the private shipyards are being worked out. It would also provide the Navy with an increased shipbuilding capacity which might be needed in the event of increased shipbuilding programs.

4. Until the alternative of building nuclear submarines at Navy shipyards has been fully evaluated, it would be improvident to request a Presidential determination to build nuclear submarines at private shipyards. Accordingly, I request you specifically exclude the Fiscal Year 1981 nuclear submarines from the request for a Presidential determination to build warships in private shipyards.

5. I have returned the previously prepared request for a Presidential determination to the Congressional Affairs Branch, Congressional/Public

Affairs Directorate, with my concurrence subject to excluding the Fiscal Year 1981 nuclear submarines from the request. I would appreciate being advised of the actions you plan to take on this matter.

H. G. Rickover

Copy to:
Vice Commander, Naval Sea Systems Command
Deputy Commander for Submarines,
  Naval Sea Systems Command
Deputy Commander for Contracts,
  Naval Sea Systems Command
Director of Congressional/Public Affairs,
  Naval Sea Systems Command
PMS 393
PMS 396

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

8 JAN 1981

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION

Subj: Proposed Construction in Private Shipyards of Warships
Authorized for the Navy's Fiscal Year 1981 Shipbuilding
and Conversion Program

Ref: (a) NAVSEA 08 Memorandum of 24 Sep 1980, Construction of
Nuclear Submarines in Navy Shipyards

1. In reference (a) you noted that it would be improvident to request a Presidential determination to build nuclear submarines at private shipyards until the alternative of building nuclear submarines at Navy shipyards has been fully evaluated. You requested that I specifically exclude the Fiscal Year 1981 nuclear submarines from the request for a Presidential determination to build warships in private shipyards.

2. In July, I initiated an analysis of the actions required to construct nuclear submarines in Navy shipyards. Preliminary conclusions are that substantial one-time costs are involved which would require additional Congressional action before we could proceed. The Fiscal Year 1982 budget would be the earliest that necessary funding approval could be obtained.

3. In view of the above, I am sending forward the Navy's request for Presidential authorization to construct all of the Fiscal Year 1981 warships in private shipyards. Upon completion of the Navy shipyard analysis, a decision can be made concerning future SSN 688 Class construction assignments.

4. Thank you for your suggestions in this matter.

E. B. Fowler

E. B. FOWLER

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

15 October 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Overhaul of Nuclear Powered Ships at Quincy Shipbuilding Division of General Dynamics

Encl: (1) Proposed Letter to P. T. Veliotis

1. On 7 October 1980 you provided me a copy of a 24 September 1980 letter to you from Mr. P. T. Veliotis, Executive Vice President--Marine, General Dynamics Corporation. Mr. Veliotis again proposes, as he did two years ago, that the Navy agree to assign nuclear ship overhaul work to General Dynamics' Quincy Shipbuilding Division. In response to that earlier request the Naval Sea Systems Command (NAVSEA), by letter dated 26 March 1979, informed General Dynamics that the possible need for additional shipyard capacity for the performance of post shakedown availabilities (PSA's) and selected restricted availabilities (SRA's) did not warrant the cost of establishing a submarine repair capability at Quincy and that it would be more realistic to consider accomplishing future PSA's and SRA's at Electric Boat, Groton.

2. I note that NAVSEA workload studies prior to a Chief of Naval Material letter to Commander, Submarine Force, U.S. Atlantic Fleet, dated 4 August 1980 concerning nuclear submarine overhaul capacity showed that the six existing Naval Shipyards and Newport News, which are qualified for nuclear overhaul work, could accommodate this work in the 1980's. The studies showed that an expected peak workload in 1984-1986 could be handled by using more of the capacity available in these yards for nuclear ship work. In addition, an internal NAVSEA point paper prepared in SEA 07 and dated 14 April 1980 on the subject of overhauls of nuclear powered submarines at General Dynamics Quincy contained the following conclusion:

> "The process of acquiring nuclear capability at a shipyard including the necessary qualified personnel, training, organization, procedures, facilities, and equipment requires a substantial amount of effort and a major expenditure of funds. An effort of this magnitude and cost should be undertaken only if there is an identified need for additional shipyards with nuclear capability. Since the present nuclear capability provides sufficient capacity for presently planned nuclear shipwork, further expansion is not required. If the Navy should at some point make a determination that additional Navy work needs to be performed in private shipyards to accommodate temporary surges in workload, such work should be the less complex ships including the non-nuclear combatants such as DD 963 Class, and FF 1052 Class ships, rather than the nuclear ships."

3. I recognize that more fully utilizing the existing qualified yards for nuclear ship overhauls will mean assigning more non-nuclear Navy ship work to private shipyards and some Atlantic Fleet nuclear submarine overhauls to the West Coast nuclear qualified yards. However, in my view this is a far more prudent approach than undertaking the development of a nuclear overhaul capability at an additional shipyard. The difficulties of such an undertaking, whether at Quincy or elsewhere, are such that only a long range, clearly defined deficit in capability at the existing qualified yards would warrant such a step.

4. Establishing a nuclear ship overhaul capability at Quincy would place an added drain on the Electric Boat Division. Electric Boat is already bogged down with production problems that have substantially delayed delivery of TRIDENT and SSN 688 Class submarines being built at that yard. In his 24 September letter Mr. Veliotis proposes drawing on Electric Boat to develop a nuclear submarine overhaul capability at Quincy. He states:

> "The Quincy Division would have access to the pool of Electric Boat personnel experienced in submarine overhauls. From this pool a cadre of both supervisory and senior trades personnel would be drawn to facilitate early phases of overhaul work and training of Quincy personnel."

In a letter dated 3 October 1980, however, Mr. Veliotis contends that work required by the Navy under submarine contracts at Electric Boat is taxing the company's resources. In that letter he states:

> "However, since we do not have unlimited resources of skilled personnel available to us, nor are such resources readily obtainable as a realistic matter, the extent to which the structural welding reinspection program continues to require a high level of such resources will necessarily affect our ability to cope with any continuing level of changes."

Under these circumstances, it appears that the General Dynamics proposal to establish Quincy as a nuclear submarine overhaul yard would be contrary to the Navy's interest.

5. Although in March 1979 NAVSEA concluded it would be more realistic to consider accomplishing PSA's and SRA's at Electric Boat, Groton rather than Quincy, this conclusion is no longer viable. Electric Boat, in its business relations with the Navy, seems bent on shifting to the Navy financial responsibility for all the problems at the shipyard. Electric Boat has reneged on an agreement for administering repairs to Government furnished equipment, routinely proposed delay for accomplishment of minor work items on TRIDENT, and announced it would be submitting insurance claims to cover the effects of faulty workmanship at the shipyard. These actions and others have

frustrated the Navy's efforts to meet commitments to Congress to administer contracts on a pay-as-you-go basis. Under these circumstances it would be unwise for the Navy to broaden its reliance on Electric Boat.

6. I recommend NAVSEA inform General Dynamics that the Navy does not plan to attain additional nuclear submarine repair capacity at either the Quincy Shipbuilding Division or the Electric Boat Division. A proposed reply to Mr. Veliotis for your signature is attached. In addition, I recommend that you assure necessary actions are underway or are initiated as needed to provide the necessary capacity in the six nuclear qualified Naval shipyards so that these yards, together with Newport News, will support the nuclear ship overhaul and repair workload through the 1980's.

7. I would appreciate being advised of the action you intend to take concerning this matter.

H. G. Rickover
H. G. Rickover

Copy to:
Chief of Naval Material
Vice Commander, Naval Sea Systems Command
Deputy Commander for Submarines,
 Naval Sea Systems Command
Deputy Commander for Contracts,
 Naval Sea Systems Command
Deputy Commander for Industrial and
 Facility Management,
 Naval Sea Systems Command

DRAFT

Mr. P. T. Veliotis
Executive Vice President--Marine
General Dynamics Corporation
Eastern Point Road
Groton, Connecticut 06340

Dear Mr. Veliotis:

This is in response to your letter of 24 September 1980 in which you lay out your concept for developing the capability to perform nuclear submarine overhauls at the General Dynamics Quincy yard. By drawing on Electric Boat for experienced supervisors and senior trades personnel you state that Quincy would be able to commence the first submarine restricted availability (SRA) 18 months, and the first submarine overhaul 30 months, after a decision to start doing nuclear submarine repair work at Quincy.

NAVSEA continually reviews the Navy's projected nuclear ship workload and the available shipyard capacity to accomplish that workload. Based on these reviews you were advised in March 1979 that the possible need for additional shipyard capacity to accomplish certain nuclear powered submarine availabilities and overhauls did not warrant the potential cost associated with establishing a submarine repair capability and a Supervisor of Shipbuilding, Conversion and Repair office at Quincy, and that it would be more realistic to consider accomplishing Post Shakedown Availabilities (PSA's) and SRA's at Electric Boat Division than Quincy Shipbuilding Division.

Based on studies conducted since March 1979 NAVSEA still concludes that the expected peak workload in the mid-1980's can be handled by using more of the capacity of shipyards already qualified to perform work on nuclear powered ships. Under these circumstances, the

Enclosure (1)

substantial amount of effort and expenditure of funds required to attain a nuclear capability in an additional shipyard is not warranted.

Your proposal to accomplish nuclear submarine work at Quincy includes transfer of skilled personnel from Electric Boat to Quincy. There is already a large backlog of late and undelivered ships at Electric Boat. In fact, in your letter to me of 3 October 1980 concerning TRIDENT delivery delays, you contend that you do not have unlimited resources of skilled personnel at the yard and that resolution of the defective structural weld problem affects your ability to cope with any continuing level of changes.

In addition to skilled manpower restraints, there are other reasons why the March 1979 NAVSEA conclusion that it would be more realistic to consider accomplishing future PSA's and SRA's at Electric Boat, Groton is also not viable. Electric Boat seems bent on shifting to the Navy financial responsibility for all problems at that yard, whether Government responsible or contractor responsible. This has made it extremely difficult to conduct business with your company on a proper basis. It is frustrating Navy efforts to meet commitments to Congress to administer contracts on a pay-as-you-go basis.

For the above reasons, I consider it unwise for the Navy to agree to assign submarine repair work in a manner which would either transfer skilled personnel from Electric Boat or add additional work to Electric Boat's backlog and further affect your ability to deliver ships already several years late. Accordingly, I do not intend to give your 24 September proposal further consideration.

Sincerely,

E. B. FOWLER, VADM, USN
Commander, Naval Sea
Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
22 October 1980

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Electric Boat's proposals for accomplishing revisions to TRIDENT ship construction drawings

Ref: (a) Electric Boat ltr PTV-801001 dtd 3 October 1980
(b) Electric Boat ltr LEH/80-10-9 dtd 9 October 1980
(c) My memorandum to COMNAVSEA dtd 15 October 1980
(d) Electric Boat ltr 683/HJN-6095 (CB3305) dtd 17 October 1980

1. In reference (a) Mr. P. T. Veliotis, Electric Boat General Manager, cited as one of the causes of delays in the TRIDENT construction program, the time required to agree in advance on the cost and schedule impact of accomplishing design data revisions referred to as Engineering Notices. These Engineering Notices are prepared by Electric Boat and subsequently furnished to the shipbuilder as Government furnished design data. Mr. Veliotis proposed a daily meeting between Electric Boat and Navy representatives to establish which Engineering Notices are mandatory and to obtain contractual authorization to implement them. Reference (b) provided proposed procedures for conducting these daily meetings.

2. On October 10, 1980 my representatives met with representatives of the NAVSEA Submarine Directorate and the TRIDENT Project to point out shortcomings in the Electric Boat proposed meeting procedures and to recommend revisions. In reference (c), I forwarded to you a recommended response to reference (a). I pointed out that to authorize these drawing revisions prior to fully settling the price and schedule impact as Electric Boat proposed would leave the Navy vulnerable to large, after-the-fact claims of the type we are trying to avoid. I recommended an alternative procedure predicated on the contractor coming to the daily meetings prepared to settle, prior to authorization, the price and delivery impact of mandatory drawing revisions.

3. Subsequent to reference (c) I learned that Electric Boat and Navy representatives had met on October 15, 1980 to discuss the EB proposal for daily meetings. Reference (d) is the Electric Boat version of agreements reached at that meeting. I understand that the Supervisor of Shipbuilding and Electric Boat representatives have commenced the daily meetings. Contrary to my recommendations contract changes have been authorized on an other than fully priced basis – even for minor items – leaving the Navy open to subsequent claims.

4. I recently learned that, during a meeting on October 20, 1980 the Supervisor – without prior consultation with or approval of NAVSEA 08 – authorized the accomplishment of seven Engineering Notices in areas under my technical cognizance for which Electric Boat asserted contractual authorization was required. The items involved are minor; one involves sound damping a pipe hanger and six involve minor changes to stowage foundations – including moving stowages a few inches to avoid interferences and other changes to facilitate installation by the shipbuilder. Five of the seven items were proposed as no-cost items; the proposal for the other two totals less than $5,000. Under normal circumstances contractual authorization would not have been needed for the no-cost items, however, Electric Boat – as it has in most items of late – proposed to reserve the right to later claim delay up to June 29, 1981, the lead TRIDENT estimated delivery date, on behalf of these items. This reservation of rights is contrary to the company's previous agreement under the PL 85-804 settlement to fully price changes.

5. It does not make sense to me that an Engineering Notice authorized in October 1980 (this very month) can have anything to do with delaying the lead TRIDENT (SSBN 726) to June 29, 1981. Electric Boat has been reporting since August 1980 (two months ago) that SSBN 726 would deliver on June 29, 1981. SUPSHIP readily acknowledges that accomplishment of these work items would not in any way delay the actual delivery of the lead TRIDENT. Yet because of Electric Boat's allegation of delay for these seven items and SUPSHIP's subsequent contractual authorization, the company now has the opportunity to later submit delay claims on these items.

6. The vast majority of these items are minor and are inherent in the construction of any nuclear powered lead ship. In the case of the stowage items, the contractor in most cases acknowledges that he is required by the contract to provide this work. Apparently his reservation of rights for delivery adjustment is predicated on the concept that the drawings are late to his previously estimated February 1981 delivery date for SSBN 726. Keep in mind, the company has not yet provided the Navy a firm schedule for delivery of this ship, and, in reference (a), Mr. Veliotis made it clear that he does not intend to provide such information since he claims that delivery dates are in a "state of flux" and that "until the situation becomes more stable ... predictions regarding delivery of TRIDENT ships will necessarily be relatively subjective."

7. Obviously the Navy should strive to minimize the time needed to authorize contract changes, but in so doing, it should not abandon the sound business principle of facing up to the contractual ramifications of a change before authorizing it. The procedure you have authorized for the daily meetings presumes good faith on the part of the shipbuilder. Yet our experience in recent months indicates the company is taking advantage of the Navy's need for these ships to force the Navy into issuing changes which are unpriced or which can be later used as the basis for an omnibus

claim covering all delays in ship delivery. The procedure currently used in the daily meetings will neither expedite delivery of SSBN 726 nor improve Electric Boat's chances of delivering SSBN 726 complete by 29 June 1981. Continued problems and slippages at Electric Boat make it unlikely that the company will meet even the 29 June 1981 delivery date. These problems, not Engineering Notices, are controlling ship delivery. Since the vast majority of the currently issued Engineering Notices are not in the critical path to delivery, authorizing them on an other than fully priced basis serves only to leave the Government vulnerable to delay claims.

8. I understand your procedure is intended to apply to those changes which are "mandatory." The vast majority of the "mandatory" changes represented by Engineering Notices are not mandatory in the sense of precluding a ship from going to sea and performing its mission in an emergency. They represent essential work required to get a completed ship. In an emergency, Ship's Force could no doubt jury-rig stowages, get along without permanent label plates, and so on. However, the Navy should not expect them to have to do so, especially when it is obvious that the accomplishment of these items during ship construction will not in any way delay the actual delivery date of the ship. Under these circumstances, the Navy should be able to authorize this work and have it accomplished prior to ship delivery. What stands in the way of their accomplishment, however, is Electric Boat's routine reservation of rights for contract delivery and price adjustment.

9. From time to time there may be major changes for which the need to proceed at once precludes fully pre-pricing the change. But this should not be true for the vast majority of Engineering Notices. The Navy is coming to the daily meetings prepared to authorize changes; except for occasional major items which might actually delay ship deliveries, the company should come to the meetings prepared to settle Engineering Notices on a fully priced basis.

10. I recommend that you respond quickly to Mr. Veliotis' October 3, 1980 letter along the lines I recommended in reference (c). I further recommend that you and other Navy officials take a strong stand with senior Electric Boat management and, if necessary, with General Dynamics Corporation management that the company's approach to day-to-day contract administration is unacceptable and contrary to the mandate of Congress to keep these contracts current. You should inform them that a satisfactory arrangement for administering these contracts on a pay-as-you-go basis must be worked out prior to award of any further shipbuilding contracts to General Dynamics. In this regard I recommend that you obtain General Dynamics' agreement to:

a. Provide current accurate ship construction schedules against which the Navy can evaluate Electric Boat's alleged delays.

b. Identify the price and delivery impact on the basis of individual changes.

c. Settle changes on a full and final basis.

d. Claim delay only for those items where delay can be clearly justified on the basis of ship construction schedules.

11. I also request that you reiterate to appropriate NAVSEA and SUPSHIP personnel that no contract changes are to be authorized in matters under my technical cognizance without my agreement.

12. Please advise me at your earliest convenience of the action you intend taking on this matter.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Material
Vice Commander, Naval Sea Systems Command
Deputy Commander for Submarines, Naval Sea Systems Command
Deputy Commander for Contracts, Naval Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

23 October 1980

MEMORANDUM FOR THE GENERAL COUNSEL OF THE NAVY
COMPTROLLER OF THE NAVY

Subj: Deferred payment agreements with Electric Boat Division in connection with Armed Services Board of Contract Appeals Case No. 21737 regarding cost disallowance under "Basic Agreement Concerning Overhead Costs"

Ref: (a) My memorandum to you dated 27 August 1980

1. In reference (a) I discussed the deferred payment agreements entered into by the Navy and Electric Boat covering the payment of costs subsequently disallowed by Contracting Officer decisions which upheld the terms of the "Basic Agreement Concerning Overhead Costs." Under the deferred payment agreements, Electric Boat has delayed repayment of $27.9 million of disallowed costs pending appeal of the Contracting Officer decisions to the Armed Services Board of Contract Appeals (ASBCA). I expressed concern that the deferred payment agreements provided Electric Boat with a strong incentive to delay or avoid resolution of the dispute since Electric Boat would owe a refund to the Navy unless the ASBCA rules 100 percent for the company.

2. I recommended in reference (a) that the Navy establish with Electric Boat a firm schedule for resolution of the dispute based on the 15 October 1980 trial date previously recommended by the company. I pointed out that the Defense Acquisition Regulation and the deferred payment agreements provide that the Navy may terminate the agreements and demand repayment upon failure of the contractor to pursue diligently the resolution of its appeal. Accordingly, I recommended that the deferred payment agreements be rescinded and the disallowed amounts be recovered if the company failed to cooperate in establishing or adhering to the schedule.

3. To date I have not received a response to reference (a). The previously recommended 15 October 1980 trial date has passed. Not only has the trial not started, but to date no trial date has been set and, to my knowledge, no schedule has been established for resolution of the dispute. In the meantime, Electric Boat continues to enjoy the benefits of the deferred payment agreements by withholding payments due the Navy.

4. The Navy should not allow the company to continue to profit from undue delays caused by Electric Boat's attempts to stretch

out litigation. Therefore, I reiterate my previous recommendation that a firm schedule for resolution of the dispute be established immediately. If such a schedule cannot be established or followed, the disallowed amounts should promptly be recovered from Electric Boat.

5. I would appreciate the courtesy of a reply to this memorandum and to reference (a) advising me of the action you are taking in regard to my recommendation.

H. G. Rickover
H. G. Rickover

Copy to:
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
  Sea Systems Command
Counsel, Naval Sea Systems Command

GENERAL COUNSEL OF THE NAVY
WASHINGTON, D.C. 20350

November 4, 1980

MEMORANDUM FOR THE DEPUTY COMMANDER, NUCLEAR PROPULSION DIRECTORATE,
NAVAL SEA SYSTEMS COMMAND (SEA 08)

Thank you for your memoranda dated 27 August 1980 and 23 October 1980, making recommendations regarding how ASBCA No. 21737 should be pursued and what approach should be followed with respect to the deferred payment agreements entered into by the Navy and Electric Boat. Your recommendations have been forwarded to this Office's Litigation Division, which is responsible for handling this case. The Division continues to seek trial of this matter at the earliest feasible date. In light of the interest you have expressed, I have asked that your staff be kept informed of any significant developments in the litigation or with respect to the deferred payment agreements. The Comptroller of the Navy concurs in this memorandum.

Coleman S. Hicks

Coleman S. Hicks

Copy to:
Chief of Naval Material
Comptroller of the Navy
Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval Sea
  Systems Command
Counsel, Naval Sea Systems Command
Director, Litigation Division

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
21 November 1980

MEMORANDUM FOR THE CHIEF OF NAVAL OPERATIONS

Subj: Center for Naval Analyses (CNA) study on the disruption costs in Navy shipbuilding programs

Ref: (a) CNO Memo, Ser 96/594534, dtd Oct. 24, 1980, Subj: Shipbuilding Delay and Disruption Study Report

1. On 7 November 1980 I received a copy of reference (a) which forwarded for comment a proposed letter of promulgation for the Final Study Report, Shipbuilding Delay and Disruption. According to reference (a) the study report was completed by the Center for Naval Analyses as part of its independent study program and is intended to be promulgated as a Chief of Naval Operations study.

2. I recommend that the Navy neither promulgate nor endorse the study report. Rather than facilitating the settlement of changes and thereby avoiding or minimizing future claims, the proposed approach to pricing of delay and disruption would undermine Navy efforts to protect the Government against inflated claims.

3. The study presupposes that Navy claims problems stem in large measure from disagreement between shipbuilders and the Navy as to the amount of delay and disruption caused by Government initiated changes, and that the way around this problem is for the Navy and its shipbuilders to agree to use the proposed mathematical model. It presumes that the manhours required to accomplish ship construction work depend on eight factors – number of workers, average hours per day, experience of the workforce, skill level of the workforce, ship construction sequence, hard core change hours, manhours applied to other programs, and delay in ship delivery. Using data previously collected for other purposes, or assumptions where data does not exist, CNA attempts to sort out how much each of the eight factors contributes to shipyard efficiency. CNA calculates that on the FF 1052 and DD 963 programs at Avondale and Litton respectively, disruption costs amounted to between 1½ and 2½ times the so-called hard core labor cost of a change.

4. The study concludes that shipbuilders and the Navy, working together, should be able to price out changes using the statistical cost equations developed in the report. It recommends that the Navy test the proposed change pricing formula on an ongoing program, preferably under a cost type contract, to further refine and prove out the system.

5. The mathematical techniques used in the report give an aura of accuracy and exactitude which is out of character with the shipbuilding process. I doubt that most who have been asked to comment on the report will read it – or that those who do will know whether the authors were correct in using the "Cobb-Douglas log linear cost equation" rather than the "Leontief and Translog equations" or whether the "Durbin-Watson test statistic for serial error correlations" and the "Cochrane-Orcutt generalized least squares estimates of the equations" are appropriate for this study. Neither do those asked to comment on the report have ready access to the data and even some of the equations used in the study, nor the wherewithal to evaluate its accuracy – certainly not by the close of business on 21 November 1980, the date by which comments were requested.

6. The underlying premise of the study is wrong. A statistical model along the lines of that recommended in the study would have contributed nothing to the prevention or resolution of the $2.7 billion backlog in claims that developed through the mid-1970's. Moreover it would increase the Navy's vulnerability in future claims of this sort.

7. Take, for example, the current situation at Electric Boat:

a. Submarines under construction at Electric Boat have been delayed substantially, largely due to quality control problems, including installation of discrepant contractor furnished material, defective welding, and the use of wrong kinds of paint.

b. According to the Defense Contract Audit Agency, Electric Boat to date has spent, in direct labor and material alone, more than $45 million correcting these problems.

c. In releasing its financial report for the third quarter of 1980 General Dynamics alludes to these problems but hastens to add that it expects to recover most of these costs from the Government.

d. Electric Boat has already placed the Navy on notice that under the Government insurance provisions of Navy shipbuilding contracts it will claim a contract adjustment for all costs attendant to these problems.

8. Although the Navy considers Electric Boat to be not entitled to a contract adjustment for these problems, there is no question that the company will eventually submit a large omnibus claim in one form or another in an effort to get the Navy to underwrite Electric Boat's own financial problems. No doubt delay and disruption will constitute a large portion of such a claim. In past claims the difference between the amount the contractor could attribute to matters alleged to be Government responsible and the total amount claimed was frequently attributed to delay and disruption.

9. The Ship Acquisition Contract Administration Manual (SACAM) presently sets forth guidelines for analyzing delay and disruption. Under these guidelines the contractor is expected to provide facts and data upon which to substantiate his claim. The Navy Claims Settlement Board has followed this approach in analyzing Electric Boat's past claims.

10. With perhaps hundreds of millions of dollars at stake, as potentially is the case at Electric Boat, the Navy should not be lured away from evaluating delay and disruption claims on their individual merits. Were the Navy to adopt a formula approach along the lines the CNA study suggests, attempts to resolve delay and disruption claims would degenerate into unresolvable disputes over which equations, models, and assumptions most accurately simulate the particular ship construction process whenever the Government offer is less than the contractor wants. Consultants have developed models with widely varying results — all impressive in their apparent logic and mathematical sophistication, yet all dependent on highly subjective assumptions.

11. To administer its contracts properly, the Navy must strive for simplicity. The CNA proposal leads in the opposite direction. Those who administer contracts must be able to understand what it is they are doing. Rest assured that if mathematical models such as that proposed by CNA become the basis of contract payments, contractors will hire systems analysts to "out model" the Navy. No judicial forum could reasonably be expected to be able to deal effectively with the disputes that would inevitably arise.

12. Changes typically total about 5 percent of the price of a ship. They are an inevitable part of the shipbuilding business and shipbuilders are well aware of this. For the most part, shipbuilders price these contract changes as well as the contracts themselves using historical costs of prior ships. Cost estimates derived in this manner therefore have built into them the effects of delay and disruption incurred on prior work. To whatever target price is negotiated based on these estimates, the Navy typically agrees to absorb 80 percent or more on overruns subject to the limits of a ceiling price. In the TRIDENT and SSN 688 contracts, the so-called spread between target cost and ceiling price ranges from 30 to 52 percent of target cost. This spread provides a high degree of protection for errors in cost estimating or other risks. Further, the Navy recognizes those estimated costs of delay and disruption that the contractor can reasonably support. Thus the overall arrangement should satisfy any reasonable concern that the Navy is not fulfilling its obligation to equitably compensate its shipbuilders for the cost of changes.

13. Past experience with formula pricing shows, as the CNA report itself acknowledges, that these systems work only to the extent both parties stay satisfied with the results. The serious claims

problems however have arisen in an environment in which contractors were determined to hold out for more than the Navy concluded it owed. Thus the Navy would be better off to confine delay and disruption analysis to the specifics of the case rather than adopt a cumbersome system which works only to the extent the shipbuilder is satisfied with the results. If adopted, the CNA recommendations would result in another one-way street. In cases where the contractor is willing to accept the formula results, the formula would be the basis for rationalizing the Government payments. However, in cases where the contractor is dissatisfied, he could disavow the system.

15. In essence, a simplistic solution is being proposed to a most difficult problem which has defied the efforts of many experienced and sophisticated people. Ever since conglomerates took over Naval shipbuilding they have been chiefly interested in maximizing their profits — regardless of the means to accomplish this aim. That is the crux of the problem. The solution to human greed cannot be found by means of a mathematical model.

16. In summary I recommend against CNO issuance or endorsement of this study. I further recommend that the Navy cancel other efforts which have been underway for many years to derive a simple formula approach for pricing delay and disruption. As explained above, shipbuilders have ample protection under the present contract procedures for recognition and payment of legitimate delay and disruption they can reasonably substantiate.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
 (Manpower, Reserve Affairs, &
  Logistics)
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
  Naval Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
OFFICE OF THE CHIEF OF NAVAL OPERATIONS
WASHINGTON, D.C. 20350

IN REPLY REFER TO
Ser 00/500003
2 January 1981

MEMORANDUM FOR THE DEPUTY COMMANDER NAVAL SEA SYSTEMS COMMAND, NUCLEAR PROPULSION DIRECTORATE

Subj: Center for Naval Analyses (CNA) Study on the Disruption Costs in Navy Ship Building Programs

Ref: (a) Your memorandum of 21 November 1980

1. In reference (a) you recommended that the Navy should neither promulgate nor endorse the CNA independent study "Analysis of Disruption Costs in Navy Ship Building Programs." I agree.

2. As you must know, CNA initiatives such as the above study are often undertaken independently from the Navy Studies and Analysis Program. Such occurred in the instant case. They are normally promulgated by CNA although, in this case, CNA requested Navy staffing and review for potential promulgation as a CNO study. This will not be done; however, such comments as may stem from the Navy review will be provided to CNA for use in promulgating the study should they chose to do so under CNA cover.

T. B. HAYWARD

Copy to:
ASN (MRA&L)
General Counsel of the Navy
CHNAVMAT
COMNAVSEASYSCOM

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
11 December 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: General Dynamics (Electric Boat Division) delay to resolution of Armed Services Board of Contract Appeals Case No. 21737 regarding disallowed overhead costs under the "Basic Agreement Concerning Overhead Costs"

Encl: (1) My memorandum to the General Counsel of the Navy and Comptroller of the Navy dated 27 August 1980
(2) My memorandum to the General Counsel of the Navy and Comptroller of the Navy dated 23 October 1980
(3) General Counsel of the Navy memorandum to me dated 4 November 1980

1. The purpose of this memorandum is to inform you of General Dynamics' (Electric Boat Division) actions in dragging out pre-trial activities of the so-called "Electric Boat Overhead Case" and to request your assistance in forcing this dispute to trial.

2. This dispute, which is one of the largest cases presently before the Armed Services Board of Contract Appeals (ASBCA), has now been in litigation for nearly four years. It involves overhead costs incurred by Electric Boat in excess of mutually agreed overhead cost ceilings set forth in the "Basic Agreement Concerning Overhead Costs" for the years 1973 through 1975. In 1977, the Navy issued three contracting officer decisions which upheld Defense Contract Audit Agency cost disallowances in accordance with terms of the Basic Agreement and demanded repayment of $27.9 million. The contracting officer decisions were appealed by Electric Boat to the ASBCA. At the time of the appeals, Electric Boat was experiencing cash flow problems due to large cost overruns on its SSN 688 Class submarine construction contracts. Because of the Electric Boat cash flow problem, the Navy entered into deferred payment agreements with the shipbuilder under which the Navy agreed not to recoup the $27.9 million in overpayments pending resolution of the dispute.

3. (Deleted. Release of this paragraph was denied pursuant to a recent request submitted under the Freedom of Information Act. The request was submitted by an attorney whose law firm frequently represents Electric Boat Division.)

4. The Litigation Division's efforts to bring this case to trial promptly have been thwarted by Electric Boat. Electric Boat, as stated previously, had recommended, earlier this year, a trial date of 15 October 1980. Due primarily to delays caused by Electric Boat in completing depositions, the recommended date was not met. Subsequently, the Litigation Division requested the ASBCA to set a trial date no later than January 1981. Electric Boat then responded in a letter to the ASBCA on 12 November 1980 stating that the Navy's request for a trial date no later than January 1981 "is both cavalier and reflective of respondent's one sided view of this appeal."

5. In addition to objecting to the Litigation Division's request for a trial date, Electric Boat continues to stretch out the discovery process. Despite the fact that there have been several rounds of discovery starting in 1977, the company submitted on November 26, 1980 a new set of interrogatories and requests for documents. It is obvious that these continued rounds of discovery will serve no purpose but to further prolong the start of the trial. This seems an excellent way to prevent the issue from ever coming to trial.

6. This case illustrates the difficulty the Navy faces in prosecuting disputes with private shipbuilders. Despite the efforts of the Litigation Division, Electric Boat has succeeded to date in keeping the case from coming to trial on its merits. As the case drags on, the company's chances of winning improve due to the turnover of Government personnel and the tendency of Government officials to lose interest and seek ways of resolving old cases by compromise - regardless of the merits of the case.

7. The deferred payment agreements which have allowed Electric Boat to use $27.9 million of public funds over the past four years are explicitly conditioned on the company's diligent prosecution of its appeals. The record shows that Electric Boat has failed to meet its obligations. Had the Navy recouped the $27.9 million several years ago, I am certain the company would be prosecuting its case more diligently. However, as long as

8. Electric Boat appealed this case to the ASBCA in January 1977, prior to you taking office. You addressed this dispute in testimony regarding the Electric Boat P.L. 85-804 claims settlement before the House Committee on Armed Services on August 3, 1978. You stated that you saw no advantage for the Navy to include the overhead dispute in the P.L. 85-804 claims settlement. At that time there was no trial date established for hearing the case before the ASBCA. Now, almost two and one-half years after the P.L. 85-804 hearings, there is still no trial date.

9. (Deleted. Release of this paragraph was denied pursuant to a recent request submitted under the Freedom of Information Act. The request was submitted by an attorney whose law firm frequently represents Electric Boat Division.)

10. If the Navy is ever to be successful in discouraging frivolous claims and promptly resolving contract disputes, it must be able to cope successfully with large contractors and highly paid claims lawyers who seek to frustrate resolution of these disputes on their merits. I would appreciate you looking into this matter and informing me of the action you take with respect to the above.

H.G. Rickover

Copy to:
General Counsel of the Navy
Comptroller of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
 Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
13 December 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

Subj: Request for response to recommendations I have submitted regarding problems relating to Naval ship construction

Ref: (a) My memorandum to SECNAV dated 10 December 1980
(b) My memorandum to SECNAV dated 11 December 1980
(c) My memorandum to SECNAV dated 12 December 1980

1. In the past few days I have sent you three important memoranda – references (a), (b), and (c). Reference (a) contains specific recommendations for your prospective meeting with senior shipbuilding executives on December 17, 1980. Reference (b) requests your assistance in keeping General Dynamics from continuing to drag out the Electric Boat overhead case that has been pending for years before the Armed Services Board of Contract Appeals without yet coming to trial. Reference (c) requests your assistance in getting the Navy Office of General Counsel to promptly forward to the Department of Justice a formal report I submitted one year ago citing three cases of apparent violations of fraud and false claim statutes by a claims lawyer.

2. In the past I have written numerous letters to the Navy Secretariat regarding shipbuilding and related problems extending back to the time when you took over primary responsibility for these problems, first as Assistant Secretary of the Navy and later as Secretary. Rarely have I received a response.

3. Senior Defense Department officials frequently encourage subordinates to recommend economy in Government. As a means of accomplishing this goal, special programs, such as the Beneficial Suggestions Program, have been established. Although the ideas submitted under such programs frequently concern minor items, the Department instructions call for those in charge to act upon them and inform the subordinate of the action taken. In my opinion the recommendations I have submitted are at least worthy of equal consideration as those submitted under the Beneficial Suggestions Program.

4. The actions recommended in references (a) through (c) are items that you can and should act upon prior to leaving office. I respectfully request, therefore, that you give these matters your personal attention. If you do not consider the recommendations I have made worthy of implementation, I request the courtesy of being informed of the reasons for that determination.

H. G. Rickover
H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
24 December 1980

MEMORANDUM FOR THE DEPUTY SECRETARY OF DEFENSE

Subj: Request for assistance in obtaining answers to recommendations for improvement in Government operations

Encl: (1) My memorandum to SECNAV dated 10 December 1980
(2) My memorandum to SECNAV dated 11 December 1980
(3) My memorandum to SECNAV dated 12 December 1980
(4) My memorandum to SECNAV dated 13 December 1980

1. Enclosures (1) through (3) are memoranda I recently sent to the Secretary of the Navy regarding various procurement related problems together with my recommendations for Secretarial action. In enclosure (4), I invited his attention to the fact that his record for answering mail left something to be desired, and requested in particular that he take the actions recommended in enclosures (1) through (3) prior to leaving office.

2. You may recall that during your tenure as Secretary of the Navy, when Mr. Hidalgo was Assistant Secretary, I submitted various memoranda to you and your senior staff pertaining primarily to shipbuilding claims and related matters. I am still experiencing the same problem that I had prior to your departure, namely, I rarely receive even an acknowledgement, let alone a substantive response, to memoranda I send to the Navy Secretariat.

3. Although only about two weeks have elapsed since I sent my most recent memoranda to Secretary Hidalgo, I am concerned that the issues I raised might once again be ignored. Enclosure (1), for example, pointed out that General Dynamics has been setting up the Government for a large claim; Litton is pursuing large claims on cost reimbursement contracts; and Newport News, through the Shipbuilding Council of America, is trying to enlist the support of other shipbuilders in opposing Navy efforts to preclude large, after-the-fact claims through the Navy's Notification of Changes Clause. I urged therefore that at the meeting he was going to have with the shipbuilders on December 17, 1980, he should make clear that he supports the Navy efforts to administer contracts on a pay-as-you-go basis and that the Navy does not intend to tolerate false and inflated claims.

4. Enclosure (2) requested Secretary of the Navy assistance in keeping General Dynamics from continuing to drag out the Electric Boat overhead case that has been pending for years before the Armed Services Board of Contract Appeals without yet coming to trial. Enclosure (3) requested his assistance in getting the Navy Office of General Counsel to promptly forward to the Department of Justice a formal report I submitted one year ago citing three cases of

apparent violations of fraud and false claim statutes by a claims lawyer. If I wait several more weeks for a response to these letters, the present Secretary will be gone and action further delayed until his successor can turn his attention to the problems.

5. Defense Department personnel are often enjoined to improve efficiency and economy in Government. These ends are not served when subordinates perceive that, without explanation, their recommendations are being systematically ignored.

6. The practice of not responding to my various recommendations started with your arrival in office as Secretary of the Navy. It has occurred to me, therefore, that perhaps Secretary Hidalgo, in not responding to my recommendations, is simply carrying out a policy that you, as his superior, have imposed.

7. I am under no illusion that you or Secretary Hidalgo will, at this late date, answer all the memoranda I have sent you. However, action can and should be taken by the Secretary of the Navy — or by you, if you have imposed constraints upon him — to respond to enclosures (1) through (3) prior to your possible departure. Therefore, I am raising this issue with both you and Secretary Hidalgo.

8. I respectfully request that you consider including these items on your agenda of duties to be accomplished prior to departure from office. I would appreciate receiving a reply to this memorandum.

H. G. Rickover
H. G. Rickover

Copy to:
General Counsel, Department of Defense
Secretary of the Navy
General Counsel of the Navy
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Counsel, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
  Sea Systems Command

THE DEPUTY SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

January 16, 1981

Admiral H. G. Rickover, USN
Deputy Commander for Nuclear Power
Naval Sea Systems Command
Navy Department
Washington, D.C. 20362

Dear Admiral Rickover:

I have read and carefully considered the memoranda to the Secretary of the Navy you forwarded with your memorandum to me of December 24. I am acquainted with the issues discussed in these memoranda, having been directly concerned with most of them both in my present capacity as Deputy Secretary of Defense and in my earlier capacity as Secretary of the Navy.

I have passed along to my able successor, Frank Carlucci, your memoranda as well as my recommendations with respect to them.

Sincerely,

Graham Claytor

W. Graham Claytor, Jr.

JAN 2 1 1981

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
29 December 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

1. Today's edition of The Washington Star states:

> "Mr. Hidalgo asserted in an interview last week that Admiral Rickover sought to hamper the construction of the TRIDENT submarines, which are intended to carry missiles as part of the nation's nuclear deterrent force, by trying to create ill will between the Navy and the shipbuilder."

2. The New York Times version of this interview cites the same quote, but states that you did not name me "directly". The Times article, however, said that you left no doubt that I was the target of your criticism and that it was I to whom you referred as "chanting alarm and chanting doom without any justification or basis for that at all". You are quoted as having said that such predictions were "provocations" that were "unfair" to both the Navy and the shipbuilder and that they "have a negative effect on national security".

3. These are most serious charges for a Secretary of the Navy to make against a senior Naval Officer, whether directly or by strong implication as the Times article suggests. If the thrust of the Times and Star articles correctly reflects your views, I question why I had to read of these charges for the first time in the press. Certainly the many memoranda I have sent you during the past two years have afforded ample opportunity for you to tell me of any concerns you might have that I was seeking "to hamper construction of the TRIDENT submarines".

4. If these charges are true, they warrant prompt disciplinary action by you against whomever you are referring to. It is for this reason I am sending a copy of this letter to the Judge Advocate General of the Navy.

5. Since the press seems to think your comments were aimed at me, I respectfully request that I promptly be informed whether or not they were, together with the facts behind these charges.

H. G. Rickover

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Judge Advocate General of the Navy

Washington Star - 12/29/80

Navy Secretary Faults Rickover

Secretary of the Navy Edward Hidalgo, who is scheduled to leave office Jan. 20, has fired a parting salvo evidently aimed at Adm. Hyman G. Rickover, the independent-minded proponent of nuclear power at sea.

Hidalgo asserted in an interview last week that Rickover sought to hamper contruction of the Trident submarines, which are intended to carry missiles as part of the nation's nuclear deterrent force, by trying to create ill will between the Navy and the shipbuilder.

The first of the Tridents, the Ohio, was originally scheduled for delivery in May 1979. The date was later revised to June 1981 because of faulty workmanship, steel that did not meet specifications and changes ordered by the Navy in design, engineering and equipment.

In recent disclosures to the news media, unnamed critics of the program have alleged that the Ohio would not be delivered until 1982. Hidalgo called the prediction "completely irresponsible" and asserted that the ship would be delivered in mid-1981.

"No constructive purpose is served, indeed a very negative purpose is served, by chanting alarm and chanting doom without any justification or basis for that at all," Hidalgo said. He said such predictions were "provocations" that were "unfair" to both the Navy and to the shipbuilder, the Electric Boat Co., a subsidiary of General Dynamics.

In response to question, Hidalgo said, "I think by his own words that Admiral Rickover seems to have a different view of the situatioin than I do."

New York Times Service

NY Times 29 Dec 1980

SECRETARY OF NAVY CRITICIZES RICKOVER

Says He Hurts Trident Program by Suggesting Contractor Won't Meet Delivery Schedule

By RICHARD HALLORAN

Special to The New York Times

WASHINGTON, Dec. 28 — The Secretary of the Navy, Edward Hidalgo, who is scheduled to leave office Jan. 20, has fired a parting salvo evidently aimed at Adm. Hyman G. Rickover, the independent-minded proponent of nuclear power at sea.

Without naming him directly, Mr. Hidalgo asserted in an interview last week that Admiral Rickover sought to hamper the construction of the Trident submarines, which are intended to carry missiles as part of the nation's nuclear deterrent force, by trying to create ill will between the Navy and the shipbuilder.

The first of the Tridents, the Ohio, was originally scheduled for delivery in May 1979. The date was later revised to June 1981, because of faulty workmanship, steel that did not meet specifications and changes ordered by the Navy in design, engineering and equipment.

In recent disclosures to the news media, unnamed critics of the program have alleged that the Ohio would not be delivered until 1982. Mr. Hidalgo called the prediction "completely irresponsible" and asserted that the ship would be delivered in mid-1981.

'Chanting Alarm'

Then, taking apparent aim at Admiral Rickover, Mr. Hidalgo said, "No constructive purpose is served, indeed a very negative purpose is served, by chanting alarm and chanting doom without any justification or basis for that at all."

Mr. Hidalgo said such predictions were "provocations" that were "unfair" to both the Navy and to the shipbuilder, the Electric Boat Company, a subsidiary of General Dynamics.

"They were unfair to both sides and I think they, indeed, have a negative effect on national security," Mr. Hidalgo said.

Mr. Hidalgo left no doubt as to the target of his criticism. In response to a question on that point, he said: "I think by his own words that Admiral Rickover seems to have a different view of the situation than I do."

Admiral Rickover's office said that he was away on leave and was not available for comment. The 80-year-old father of the nuclear Navy has become something of an institution in Washington and has usually been immune to criticism.

Dispute Over Contract Settlement

The roots of the conflict between the Secretary and the Admiral appear to go back to June 1078, when Mr. Hidalgo, then an assistant secretary of the Navy, arranged a $2.8 billion compromise settlement between the Navy and three shipbuilders, including Electric Boat, on cost overruns on Navy contracts.

At that time, Admiral Rickover publicly and vigorously opposed the settlement, contending that the shipbuilders should be kept to the letter of their contracts even though many of the additional costs were caused by changes ordered by the Admiral or his staff.

The dispute between the Secretary and the Admiral simmered until earlier this year, when a memo from Admiral Rickover to Mr. Hidalgo found its way into print in a trade publication, Defense Week, devoted to military affairs. The memo said that it was "only a matter of time until the Navy will again be confronted with omnibus claims" from shipbuilders who will try to blame the Navy for more cost overruns. The Navy has inspectors, who are under Admiral Rickover's general supervision, in the shipbuilding yard.

Delay as Campaign Issue

Mr. Hidalgo responded to the memo in a June letter to Representative Charles E. Bennett, Democrat of Florida, chairman of the Subcommittee on Seapower and Strategic and Critical Materials of the House Armed Services Committee. Mr. Hidalgo said, "There is no basis whatsoever for linking these developments with predictions for future claims comparable in any way with those in the past."

The dispute continued, largely out of sight, until recent news articles alleged that delivery of the Trident was being delayed again, until 1982. Republicans made an issue of the alleged delay in the Presidential campaign, criticizing President Carter for neglecting the nation's defense.

Then, two weeks ago, Mr. Hidalgo attended the launching of an attack submarine, the Baltimore, also built by Electric Boat. There, he delivered remarks that he said later were unprepared but that he had thought about on the way to the ceremony.

'They Want Us to Fail'

Again without mentioning Admiral Rickover directly, Mr. Hidalgo said, "I think it is well for us to realize that all our dreams, all our ambitions, all our fulfillments, are not unopposed."

Referring to what he called "an avalanche of this opposition lately," the Secretary said, "Those who do not wish us well would do well to understand that we are going ahead and succeed not only in spite of but because of their opposition and because of their irresponsible criticism."

"They want us to fail," Mr. Hidalgo asserted. "We shall not fail."

Elaborating on those remarks in last week's interview in his Pentagon office, Mr. Hidalgo said that he had spoken out because of "an accumulation of things." There has been a "continuous suggestion" in newspapers and magazines that more problems for the Trident program are on the way, Mr. Hidalgo said.

"I thought no useful purpose was served by talking of things that hadn't happened, particularly in view of the long history of the negative consequences," the Secretary said.

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

8 January 1981

The Honorable Charles E. Bennett
House of Representatives
Washington, D. C. 20515

Dear Mr. Bennett:

Today I received your letter dated December 29, 1980 in which you said you had been called a number of times on that day relative to the TRIDENT submarine program and possible delays in that program. You said you were trying to understand the matter and would appreciate a memorandum or note from me on the subject.

I presume the calls you received on December 29th were prompted by articles that appeared in the *New York Times* and in the *Washington Star* on that date, apparently based on an interview between Secretary of the Navy Hidalgo and a *New York Times* reporter.

According to these articles Secretary Hidalgo asserted that I " ... sought to hamper the construction of the TRIDENT submarines, which are intended to carry missiles as part of the nation's nuclear deterrent force, by trying to create ill will between the Navy and the shipbuilder.". In addition the *Times* article cites other criticisms made by the Secretary which the *Times* said were obviously directed at me.

I have no idea of the basis for the statements that appeared in the press. Since Secretary Hidalgo was not in his office on 29 December 1980 when I called him, I wrote him the attached letter asking whether or not his charges were aimed at me and the facts behind these charges.

To date I have received no response from the Secretary. In view of the importance of this matter and my inability to get a response to my letter, you may wish to pursue this matter directly with the Secretary of the Navy.

Respectfully,

H G Rickover
H. G. Rickover

Attachment
My Memorandum for the Secretary
of the Navy dated 29 December 1980

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
29 December 1980

MEMORANDUM FOR THE SECRETARY OF THE NAVY

1. Today's edition of The Washington Star states:

> "Mr. Hidalgo asserted in an interview last week that Admiral Rickover sought to hamper the construction of the TRIDENT submarines, which are intended to carry missiles as part of the nation's nuclear deterrent force, by trying to create ill will between the Navy and the shipbuilder."

2. The New York Times version of this interview cites the same quote, but states that you did not name me "directly". The Times article, however, said that you left no doubt that I was the target of your criticism and that it was I to whom you referred as "chanting alarm and chanting doom without any justification or basis for that at all". You are quoted as having said that such predictions were "provocations" that were "unfair" to both the Navy and the shipbuilder and that they "have a negative effect on national security".

3. These are most serious charges for a Secretary of the Navy to make against a senior Naval Officer, whether directly or by strong implication as the Times article suggests. If the thrust of the Times and Star articles correctly reflects your views, I question why I had to read of these charges for the first time in the press. Certainly the many memoranda I have sent you during the past two years have afforded ample opportunity for you to tell me of any concerns you might have that I was seeking "to hamper construction of the TRIDENT submarines".

4. If these charges are true, they warrant prompt disciplinary action by you against whomever you are referring to. It is for this reason I am sending a copy of this letter to the Judge Advocate General of the Navy.

5. Since the press seems to think your comments were aimed at me, I respectfully request that I promptly be informed whether or not they were, together with the facts behind these charges.

H. G. Rickover

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command
Judge Advocate General of the Navy

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

16 January 1981

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Notification of Changes clause for future shipbuilding contracts

Ref: (a) My memorandum to CNM dated 7 January 1981
(b) CNM memorandum to me dated 14 January 1981

1. On Tuesday, January 6, you and I discussed several problems which resulted from Secretary Hidalgo's direction to award a new TRIDENT shipbuilding contract to Electric Boat using Electric Boat's version of the Notification of Changes clause. Concerning the Navy's vulnerability to future cross contract impact claims, you informed me that Assistant Secretary Doyle was under the impression that the Navy would be protected against cross contract impact claims between the TRIDENT and the SSN 688 Class programs once the Electric Boat version of the clause was included in the next SSN 688 Class contract.

2. By reference (a) I advised you that Secretary Doyle's impression was not correct since even with a new SSN 688 Class contract the Navy would still be vulnerable to cross contract impact claims between:

a. The new TRIDENT contract and previous SSN 688 Class contracts, and

b. A new SSN 688 Class contract and previous TRIDENT contracts.

I also stated in reference (a) that I believed the problem warrants being raised to the highest levels of General Dynamics management with the Navy Secretariat insisting on elimination of the Electric Boat loophole.

3. By reference (b) you agreed that the Electric Boat version of the Notification of Changes clause would not provide complete protection from cross contract impact claims even if included in a new SSN 688 Class contract in addition to the new TRIDENT contract. You further stated that you did not believe it would be to our advantage to reopen the old TRIDENT and SSN 688 Class contracts and intended no further action.

4. The problem with the Electric Boat version of the clause is that new contracts with the clause are vulnerable to cross contract impact claims from previous contracts. The NAVSEA version of the clause would protect a new contract from such claims. I agree that it would be virtually impossible to obtain Electric Boat's agreement to backfit their version of the clause into existing contracts. In

reference (a) I was supporting the NAVSEA version of the Notification of Changes clause for the new TRIDENT contract and not recommending the backfit of the clause into existing contracts with Electric Boat.

5. Even though NAVSEA was directed by the Secretary to accept the Electric Boat loophole for the new TRIDENT contract, I consider the Navy should not accept this loophole in any future shipbuilding contracts. The NAVSEA Notification of Changes clause was designed to enable shipbuilding contracts to be administered on a pay-as-you-go basis consistent with commitments made to Congress to keep contracts current and avoid large after-the-fact claims.

6. To ensure that the Electric Boat version of the Notification of Changes clause does not become a precedent for future shipbuilding contracts, I recommend you take the following actions:

a. Modify the Navy Contracting Directives to require the use of the NAVSEA Notification of Changes clause in all future shipbuilding contracts.

b. Advise the shipbuilding industry of the Navy's policy to use the NAVSEA clause without deviation.

7. I would appreciate being advised of your actions in this matter.

H. G. Rickover

Copy to:
Secretary of the Navy
Assistant Secretary of the Navy
 (Manpower, Reserve Affairs & Logistics)
General Counsel of the Navy
Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
 Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF DEFENSE
UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
HEADQUARTERS NAVAL MATERIAL COMMAND
WASHINGTON, D.C. 20360

IN REPLY REFER TO
Ser 00/0075
22 Jan 1981

MEMORANDUM FOR THE DEPUTY COMMANDER FOR NUCLEAR PROPULSION,
NAVAL SEA SYSTEMS COMMAND

Subj: Notification of Changes Clause for Future Shipbuilding Contracts

Ref: (a) Your memo of 16 Jan 81, same subject

1. In reference (a) you recommended that I take action to modify the Navy Contracting Directives to require the use of the NAVSEA Notification of Changes clause in all future shipbuilding contracts and advise the shipbuilding industry that the Navy will use the NAVSEA clause without deviation.

2. As you know, we have all pursued the policy objective of avoiding and eliminating the opportunity for large after-the-fact claims. The Ship Acquisition Advisory Council, in its conclusion on an earlier version of the NAVSEA clause, supported trial use and implementation in appropriate contracts and the current NAVSEA Notification of Changes clause continues to be in consonance with our stated policy objective.

3. I am concerned, as I know you are, that we have no contract at this time that contains the current clause; therefore, we have had no opportunity to observe its operation and determine whether further iterations of the clause are necessary to support the policy objective. I am aware that the clause is in solicitations for the FY 80/81 SSN-688 Class; the FY 81/82/83 FFG-7 Class; the FY81 LSD-41 Class; and is planned for the CG-49/50 TICONDEROGA Class. With the clause in these solicitations we are giving the shipbuilding industry a clear signal of our policy.

4. With regard to publishing the clause in the NCD, your recommendation has merit and is acceptable to me, and I will take action to publish the clause in the category "When Applicable." Publishing the clause in this category rather than as a "Required" clause is prudent at this time, since the clause is in current solicitations and the results of its trial use are unknown. After we view additional aspects of the shipbuilding industry's acceptance of the clause we may want to make some refinements. At that time it would be proper to place the clause in the "Required" category. By this action, granting of deviations should be minimal, and the intent of your recommendation to use the clause without deviation would be served.

A. J. WHITTLE, JR.

Copy to:
General Counsel of the Navy
Commander, Naval Sea Systems Command

DEPARTMENT OF DEFENSE UNITED STATES OF AMERICA

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
23 January 1981

MEMORANDUM FOR THE CHIEF OF NAVAL OPERATIONS

Subj: Center for Naval Analyses (CNA) study on the disruption costs in Navy shipbuilding programs

Ref: (a) My memorandum to CNO dated 21 November 1980
(b) CNO memorandum to me, Ser 00/500003, dated 2 January 1981

1. In reference (a) I recommended that the Navy should neither promulgate nor endorse the Center for Naval Analyses (CNA) independent study, "Analysis of Disruption Costs in Navy Shipbuilding Programs." In reference (b) you agreed.

2. Reference (b) further pointed out that this study was undertaken independently from the Navy Studies and Analysis Program and that while it will not be promulgated as a CNO study, " ... such comments as may stem from the Navy review will be provided to CNA for use in promulgating the study should they choose to do so under CNA cover."

3. I recommend the Navy take steps to preclude the CNA from issuing the subject report even "under CNA cover." The name of this private organization and its total dependence on Navy funding make it appear that all its actions are Navy sponsored. This is particularly true in the case of the subject report, since CNA states that the study was prompted by a Navy request. Since the study was funded under a Navy contract, the Navy should have the right to scrap the entire effort.

4. Reference (a) detailed my reasons why the concept promoted in the subject study is not in the Navy's best interests. As noted in reference (a), shipbuilders have ample protection under present contract procedures for recognition and payment of legitimate delay and disruption costs which they can reasonably substantiate. Adoption of mathematical equations to pay alleged delay and disruption costs, not substantiated by the shipbuilders involved, would unnecessarily complicate the administration of shipbuilding contracts and lead to additional contract disputes which will be difficult to resolve. Such an approach would not preclude the serious claims the Navy has experienced in the past in which contractors were determined to hold out for more than the Navy concluded it owed.

5. In reference (a), I further recommended that the Navy cancel other efforts which have been underway for many years to derive a simple formula approach for pricing delay and disruption. Reference (b) did not address this recommendation. The Navy should prohibit

the waste of its money and manpower on efforts like the subject study to develop formula approaches for automatically pricing unsubstantiated delay and disruption costs. If such a policy is not clearly established, it will only be a matter of time before someone else is once again wasting money developing such a formula to waste additional Navy money.

6. I would appreciate being informed of the action you take on my recommendations to (1) preclude the CNA from issuing the subject report even "under CNA cover" and (2) abandon efforts to develop pricing formulas for delay and disruption.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
(Manpower, Reserve Affairs & Logistics)
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
Naval Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
OFFICE OF THE CHIEF OF NAVAL OPERATIONS
WASHINGTON, D.C. 20350

IN REPLY REFER TO
Ser 00/300055
14 February 1981

MEMORANDUM FOR THE DEPUTY COMMANDER NAVAL SEA SYSTEMS COMMAND, NUCLEAR PROPULSION DIRECTORATE

Subj: Center for Naval Analyses (CNA) Study on Disruption Costs in Navy Ship Building Programs

Ref: (a) Your memo of 23 January 1981

1. In reference (a), you recommended that the Navy take steps to preclude CNA from issuing the subject study, even under CNA cover. I simply don't agree with that recommendation.

2. The studies program is supposed to provide the Navy with objective and independent perspectives to aid in decision making. Moreover, our contract with the University of Rochester affirms a high degree of independence on the part of CNA. We would undermine that if we terminated or kept from promulgation competent analyses with which we disagreed.

3. I shall stick to my previous decision to let the study stand as an independent effort by CNA.

T. B. Hayward
T. B. HAYWARD

Copy to:
ASN (MRA&L)
General Counsel of the Navy
CHNAVMAT
COMNAVSEASYSCOM

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
17 February 1981

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Ceremonial expenses in Naval ship construction at private yards

Ref: (a) SECNAV memo for CNO dtd 1 March 1977
(b) SECNAV memo for CNO dtd 5 July 1977
(c) DCAA Report No. 6461-0A179370-001 dtd 11 Sept. 1980
(d) DCAA Report No. 2360-1W179100 of 12 Nov. 1980

1. In references (a) and (b) then Secretary of the Navy Claytor established a policy aimed at reducing the Government's financial burden in ship keel laying, launching, and commissioning ceremonies. Reference (a) stated, "... expensive, time-consuming keel laying ceremonies should be the exception rather than the rule." Reference (b) stated, for launching and commissioning ceremonies: "To the extent that Navy decision making and responsibility are involved, Navy officials should effect all reasonable reductions in the cost of such ceremonies." The purpose of this memorandum is to express my concern that the policy established in references (a) and (b) does not appear to be working; and to recommend that NAVSEA take action to ensure unwarranted ceremonial expenses are not charged to Navy ship construction contracts.

2. Reference (c) is the Defense Contract Audit Agency (DCAA) report of September 11, 1980 regarding ceremonial launching costs for SSN 711 and CVN 70 under construction at Newport News Shipbuilding. Reference (d) is the DCAA report of November 12, 1980 regarding ceremonial costs charged to launching and keel laying of SSN 688 Class and TRIDENT Class submarines under construction at Electric Boat. These reports indicate the Navy's major private shipyards are improperly allocating ceremonial costs and generally undertaking extravagant ceremonies at the taxpayers' expense.

3. References (c) and (d) indicate Newport News and Electric Boat charged to Navy contracts the costs of receptions and dinners; film coverage of ceremonies; jewelry and gifts; excessive limousine, bus and car rentals; and excessive labor and overhead associated with ceremonial functions. Moreover, both shipbuilders charged all direct labor costs associated with the ceremonies to single accounts — combining allowable and unallowable costs. This practice makes the Government's task of determining allowability of costs extremely difficult and, according to reference (c) may violate Cost Accounting Standards. Since shipbuilders know in advance that much of the cost charged is unallowable and do not separately account for these costs, the Government is left vulnerable to paying

unwarranted sums. I understand SUPSHIP, Groton and Electric Boat representatives had agreed on an acceptable method of accounting for ship launching costs but the shipbuilder failed to use the agreed upon method in charging the costs discussed in reference (d).

4. While references (c) and (d) highlight the problem at Newport News and Electric Boat, undoubtedly other private shipyards are similarly wasteful. One would expect shipbuilders to minimize costs, thereby earning higher profit on fixed price type contract work. But apparently senior shipyard officials perceive lavish ceremonies for ship key events to be a good business practice. Such ceremonies are a promotion device for the shipbuilders, and often generate media attention – free publicity. These ceremonies allow shipyard managers to entertain political guests, senior Navy officials, and shipyard employees. Most of the costs are then billed the taxpayer. I suspect shipyard officials would not be so prone to engage in expensive ceremonies if the shipbuilder paid the entire bill.

5. To my knowledge, the Navy's policy of austerity in key event ceremonies is still in force. However, the policy appears to be widely disregarded. To ensure NAVSEA ship construction contracts comply with the policy, I recommend you take action along the following lines:

a. Issue instructions to all Supervisors of Shipbuilding, Conversion and Repair which set forth in detail the Navy's policy regarding key event ceremonies. These instructions should limit allowable costs to a prescribed amount, not to exceed $25,000 for launchings and $10,000 for keel layings. No doubt higher amounts were originally included in the prices of shipbuilding contracts.

b. Develop a contract clause for use in all future ship construction contracts which contains the above limits on allowable ceremonial expenses. The clause should specify that these limits supersede any other contract clause which otherwise might permit the billing of ceremonial expense beyond such amounts.

6. I would appreciate being advised of the action you take in this matter. An effective program of austerity in key event ceremonies would eliminate much waste which, as you know, is a major goal of the new Administration.

H. G. Rickover

Copy to:
Deputy Commander for Contracts,
Naval Sea Systems Command
Inspector General, Naval Sea
Systems Command

01PB/LCM/920
Ser 96
MAR 1 9 1981

From: Commander, Naval Sea Systems Command

Subj: Funding of Costs Associated with Keel Laying and Launching Ceremonies at Private Shipyards

Ref: (a) Defense Acquisition Regulation (DAR) Para 15-205.11
(b) NAVCOMPT Manual 035384; Subj: Ceremonies for Keel Laying and Launching

1. Recent audit reports have focused attention on the level and kinds of costs billed by contractors to appropriated funds for ship launchings and keel layings at specified private shipyards. The purpose of this letter is to provide guidance to assure that only properly allowable costs for ship launching and keel laying ceremonies are charged to Navy Shipbuilding contracts.

2. Reference (a) makes entertainment costs unallowable. If all costs associated with keel laying and launching ceremonies for naval ships were considered to be entertainment-type expenses, then these costs would be considered unallowable. However, such ceremonies are of benefit to the Navy, and therefore, are not literally entertainment in nature. Accordingly, reasonable, minimal costs can be accepted as allowable by applying the criteria set forth in reference (b).

3. Keel laying and launching expenses not within the guidelines of reference (b) are considered to be unallowable and may not be charged to Navy Shipbuilding contracts. Cost Accounting Standard 405, which is invoked in most current shipbuilding contracts, requires that a contractor identify and exclude from billings expressly unallowable and mutually agreed to unallowable costs. Accordingly, this Standard would apply to keel laying and launching ceremony expenses which are outside the scope of reference (b).

4. Based on the above, Supervisors of Shipbuilding, Conversion and Repair, USN should take the following action:

a. If not already in effect, negotiate an agreement with each shipbuilder who conducts keel laying and launching ceremonies covering specific types of costs which may be billed under the criteria set forth in reference (b).
b. Ensure that only minimal, reasonable and properly allowable costs are booked against Navy shipbuilding contracts.

5. Although many of the costs associated with keel laying and launching ceremonies are borne by the Shipbuilder out of profits, Supervisors of Shipbuilding, Conversion and Repair, USN should, to the extent possible, encourage shipbuilders to avoid overly elaborate ceremonies.

R. B. FOWLER

Copy to:
SEA-01B
01BC
012
02X
SEA-08
90
92
93
[illegible]4

Distribution:
FKP (SUPSHIPS)

Orig: 01PB/LCM/28240/1
Typd: 01PS1/jbc/3-3-81

24 MAR 1981

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
2 March 1981

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

Subj: Newport News proposal for the inspection of a valve in ATLANTA (SSN 712)

1. The purpose of this memorandum is to inform you of the circumstances under which I authorized the Supervisor of Shipbuilding at Newport News on 25 February 1981 to issue an unpriced unilateral contract modification for the inspection of a check valve in ATLANTA (SSN 712). The work was necessary, and was authorized on an unpriced basis because of unacceptable contractual arrangements proposed by Newport News.

2. On 19 February 1981 Newport News reported that reactor plant testing on ATLANTA revealed that one of the main check valves in the reactor plant primary system was not functioning properly. On 20 February the Supervisor requested Newport News to provide a maximum priced proposal for the opening and inspection of this valve. Preliminary work in support of the inspection was authorized by the Supervisor on 21 February. The Supervisor was told that he could expect the proposal for the rest of the work on 23 February. However, despite repeated requests to the company, a proposal was not received until late in the afternoon on 25 February. The Newport News maximum price and delay proposal is summarized as follows:

a. A price increase of $4,000,000 in the contract under which ATLANTA is being built and a price increase of $2,000,000 in a subsequent contract for SSNs 716-718.

b. Delay of 38 days to delivery of each of the seven submarines under construction at Newport News under the two different contracts.

The pricing of the proposal was good only until 4:30 PM on 25 February - the same day it was submitted. For each additional day before authorization the pricing would increase by $157,000. The proposal was also conditioned on shortening from 21 days to 16 days the contractually specified period from Combined Acceptance Trials to delivery.

3. This is another case in which the contracts and financial people at Newport News seem to be taking advantage of a technical problem as a means of forcing the Navy to do work under Newport News terms. Newport News has tried for many years to get the

Navy to accept the theory of cross-contractual impact. In this case the company asserted a day-for-day delay to delivery of each of the follow ships, but did not bother to provide any justification or rationale for how this impact would occur. The Supervisor's rough estimate for this work, which I consider to be in the ball park, is a cost of about $1,000,000 and about ten days delay in ATLANTA. There should be no appreciable impact on any of the follow ships.

4. Newport News similarly provided no rationale for their proposed shortening of the period from Combined Acceptance Trials to delivery from 21 days to 16 days. This period is specified in the ship construction contracts as the period for the correction of all contractor responsible deficiencies determined to be necessary to avoid an adverse effect on the operational capability of the vessel. Like the issue of cross-contractual impact, this is another area where Newport News has historically tried to lessen its responsibilities to the Navy.

5. Authorizing the work on the Newport News terms would have set a precedent whereby any provision of shipbuilding contracts could be reopened whenever additional or revised technical work is necessary. Since the work on ATLANTA was vital to the operation of the reactor plant, it was necessary to authorize it as an unpriced unilateral contract modification.

6. Inspection of the check valve has subsequently revealed that it was blocked with a large piece of cloth material (Herculite) of the type used by the shipyard to protect equipment from exposure to the weather. The Supervisor has advised Newport News that the Navy considers this problem to be the responsibility of the shipyard. To date Newport News has not stated its position with regard to financial responsibility.

H. G. Rickover

Copy to:
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
 Naval Sea Systems Command
Deputy Commander for Submarines,
 Naval Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO

29 OCT 1981
Code 08

MEMORANDUM FOR THE COMMANDER OF THE NAVAL SEA SYSTEMS COMMAND

Subj: Proposed incentive of early delivery of CVN 71

1. This past week the Naval Sea Systems Command has been negotiating with Newport News to deliver CVN 71 approximately one year prior to the contract delivery date. I understand there is a desire for the Secretary of Defense to be able to announce agreement on such an arrangement during a launching at Newport News tomorrow.

2. As I understand the proposed arrangement, Newport News would work to the earlier delivery date as a target. The Navy and Newport News would share the escalation and other savings that would be realized by early delivery. The Newport News share of the savings would be awarded in the form of an incentive payment, providing the company met the target date. The incentive payment would decrease to the extent the company delivered the ship later than this date.

3. I just learned this evening that during negotiations Newport News has been insisting that:

a. The target date should be adjusted for various actions by government, e.g., contract changes, defective government-furnished materials, or other items of the sort that would normally entitle the contractor to an adjustment in the contract delivery date.

b. The Navy would be committed to support the target date while Newport News would only "attempt" to meet this date. The language Newport News has proposed appears to leave open the possibility that any change to the target date would entitle Newport News to a change for the contract delivery date.

4. I agree with Navy efforts to obtain an earlier delivery date from Newport News for CVN 71. During negotiations of the CVN 71 contract, the Navy repeatedly tried to get Newport News to agree to an earlier delivery date, but without success. In addition, I see nothing wrong with the concept of sharing any ensuing costs savings with Newport News, if they meet the earlier date.

29 OCT 1981
Code 08

5. I strongly recommend, however, against the Navy entering into an agreement with Newport News based on the provisions in paragraph 3 above. If the target delivery date is to be adjusted for contract changes, defective government material and the like, the Navy will run the risk of being flooded in its day-to-day business with claims for alleged delay to the target schedule.

6. This is what actually happened when the Navy incorporated delivery incentive provisions on submarine contracts during the 1960s. Some shipbuilders, to preserve their rights to the delivery incentive payment, would claim delivery impact on even minor items, which did not in reality create a problem. A contractor could deliver the ship later than the target date, and still claim the bonus by blaming the delay on government actions. Because the target delivery date was subject to adjustments, the bonus created an incentive to generate contract disputes. This made it almost impossible to settle changes. In some cases, the Navy ended up paying bonuses for ships delivered later than the original target date.

7. Under the proposed agreement, the Navy gets no improvement in contract delivery date. In these circumstances, the Navy should not commit itself contractually to support the earlier date. To do so would make the Navy vulnerable to claims.

8. The current contract price for CVN 71 is based on the longer construction schedule. Therefore, earlier delivery offers Newport News an opportunity for savings and extra profit, apart from the proposed incentive provision. Therefore, if Newport News insists in reserving the right to submit claims for adjustment of the target delivery date, I recommend that the Navy abandon the incentive payment scheme. It is not worth saddling NAVSEA with the potential of years of haggling over the alleged delivery impact of changes, deficiencies in government-furnished materials, and the like. These will inevitably arise during the remainder of the CVN 71 building period. In the final count, the prospect of additional carriers--if the shipyard performs well--should provide Newport News the greatest incentive to deliver early.

H. G. Rickover

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
3 December 1981

MEMORANDUM FOR THE ASSISTANT SECRETARY OF THE NAVY, SHIPBUILDING AND LOGISTICS

Subj: Center for Naval Analyses (CNA) study entitled "Disruption Costs in Navy Shipbuilding Programs"

Ref: (a) Center for Naval Analyses study entitled "Disruption Costs in Navy Shipbuilding Programs"
(b) OPNAV Coordination Record 81-0298 dtd 2 Nov. 1981

Encl: (1) My memorandum to the Chief of Naval Operations dated 21 November 1980

1. Reference (a) is the report of a study of disruption costs in Navy shipbuilding programs. Reference (b) recently submitted the report to the Naval Sea Systems Command for security review prior to releasing it to the public. The purpose of this memorandum is to recommend that the Navy not approve the study for public release.

2. The Center for Naval Analyses (CNA), a private organization affiliated with the University of Rochester, performed the study. In deriving a mathematical formula for pricing delay and disruption, CNA and the study's proponents believed the risk of future claims would be reduced.

3. In enclosure (1) I urged the Chief of Naval Operations neither to promulgate nor endorse the subject report. I pointed out the following:

a. The underlying premise of the study is wrong. A statistical model similar to that used in the CNA study would have contributed nothing to the prevention or resolution of the massive claims backlog that developed in the 1970's.

b. The Ship Acquisition Contract Administration Manual presently sets forth guidelines for analyzing delay and disruption. Under these guidelines, the contractor is expected to provide facts and data upon which to substantiate his claim.

c. Attempts to establish a formula along the lines the CNA study suggests would degenerate into unresolvable disputes over which equations, models and assumptions most accurately simulate the particular ship construction process.

d. Mathematical models such as that proposed by CNA are impressive in their apparent logic and sophistication, but depend on highly subjective assumptions.

4. The Chief of Naval Operations agreed with my recommendation that the Navy should not endorse the subject study but did not prevent CNA from promulgating the study on its own on the basis that the Navy's contract with the University of Rochester "affirms a high degree of independence on the part of CNA." Subsequently the President of CNA issued the study report to numerous Naval offices including Supervisors of Shipbuilding. In addition, CNA has requested Navy approval to release the report to the public.

5. I recommend you disapprove public release of the CNA report. It would be ammunition for shipbuilders in promoting change pricing theories the Navy does not endorse. Moreover, the major premises in the CNA study are wrong – contract changes are not largely responsible for claims; and the problems in resolving delay and disruption costs included in claims did not arise because of insufficient capability to evaluate such costs, if properly documented. Nearly all of the large claims of the 1970's were submitted by shipbuilders who were experiencing poor financial results on their contracts due to a variety of reasons, many of which were the responsibility of the shipbuilders. For the most part the large sums shipbuilders claimed for delay and disruption were based on legal theories that the Navy constructively changed their contracts. These legal theories were used to attribute all of the cost overruns and all of the delay in ship deliveries to the Navy. Navy analysts found many of the claim theories to be invalid.

6. Over the years consultants to the shipbuilding industry and the Navy have worked on various mathematical models and techniques for calculating delay and disruption amounts to include in the price of contract changes. Considerable time and effort has been wasted. Deriving a formula for delay and disruption will not alleviate the problem of shipbuilders who submit claims and refuse all offers to settle if the amounts offered do not achieve the shipbuilders' desired financial results.

7. Since the current Administration has expressed an interest in eliminating waste in Government, I strongly urge that you not approve the reference (a) report for public release. The study has been paid for by the Navy and already distributed to Naval authorities. I see no reason why the Navy should encourage wider distribution. Notwithstanding the fine print disclaimer contained in the report, public distribution of the report, particularly under a Center for Naval Analyses cover, will inevitably imply Navy endorsement.

8. To eliminate confusion on this point in the future, I further recommend that the Navy take steps to have the University of Rochester change the name of its Center for Naval Analyses so it cannot continue to be mistaken for an official Navy or Government organization.

H. G. Rickover

H. G. Rickover

Copy to:
Chief of Naval Operations
Chief of Naval Material
Commander, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
21 November 1980

MEMORANDUM FOR THE CHIEF OF NAVAL OPERATIONS

Subj: Center for Naval Analyses (CNA) study on the disruption costs in Navy shipbuilding programs

Ref: (a) CNO Memo, Ser 96/594534, dtd Oct. 24, 1980, Subj: Shipbuilding Delay and Disruption Study Report

1. On 7 November 1980 I received a copy of reference (a) which forwarded for comment a proposed letter of promulgation for the Final Study Report, Shipbuilding Delay and Disruption. According to reference (a) the study report was completed by the Center for Naval Analyses as part of its independent study program and is intended to be promulgated as a Chief of Naval Operations study.

2. I recommend that the Navy neither promulgate nor endorse the study report. Rather than facilitating the settlement of changes and thereby avoiding or minimizing future claims, the proposed approach to pricing of delay and disruption would undermine Navy efforts to protect the Government against inflated claims.

3. The study presupposes that Navy claims problems stem in large measure from disagreement between shipbuilders and the Navy as to the amount of delay and disruption caused by Government initiated changes, and that the way around this problem is for the Navy and its shipbuilders to agree to use the proposed mathematical model. It presumes that the manhours required to accomplish ship construction work depend on eight factors – number of workers, average hours per day, experience of the workforce, skill level of the workforce, ship construction sequence, hard core change hours, manhours applied to other programs, and delay in ship delivery. Using data previously collected for other purposes, or assumptions where data does not exist, CNA attempts to sort out how much each of the eight factors contributes to shipyard efficiency. CNA calculates that on the FF 1052 and DD 963 programs at Avondale and Litton respectively, disruption costs amounted to between 1½ and 2½ times the so-called hard core labor cost of a change.

4. The study concludes that shipbuilders and the Navy, working together, should be able to price out changes using the statistical cost equations developed in the report. It recommends that the Navy test the proposed change pricing formula on an ongoing program, preferably under a cost type contract, to further refine and prove out the system.

5. The mathematical techniques used in the report give an aura of accuracy and exactitude which is out of character with the shipbuilding process. I doubt that most who have been asked to comment on the report will read it – or that those who do will know whether the authors were correct in using the "Cobb-Douglas log linear cost equation" rather than the "Leontief and Translog equations" or whether the "Durbin-Watson test statistic for serial error correlations" and the "Cochrane-Orcutt generalized least squares estimates of the equations" are appropriate for this study. Neither do those asked to comment on the report have ready access to the data and even some of the equations used in the study, nor the wherewithal to evaluate its accuracy – certainly not by the close of business on 21 November 1980, the date by which comments were requested.

6. The underlying premise of the study is wrong. A statistical model along the lines of that recommended in the study would have contributed nothing to the prevention or resolution of the $2.7 billion backlog in claims that developed through the mid-1970's. Moreover it would increase the Navy's vulnerability in future claims of this sort.

7. Take, for example, the current situation at Electric Boat:

a. Submarines under construction at Electric Boat have been delayed substantially, largely due to quality control problems, including installation of discrepant contractor furnished material, defective welding, and the use of wrong kinds of paint.

b. According to the Defense Contract Audit Agency, Electric Boat to date has spent, in direct labor and material alone, more than $45 million correcting these problems.

c. In releasing its financial report for the third quarter of 1980 General Dynamics alludes to these problems but hastens to add that it expects to recover most of these costs from the Government.

d. Electric Boat has already placed the Navy on notice that under the Government insurance provisions of Navy shipbuilding contracts it will claim a contract adjustment for all costs attendant to these problems.

8. Although the Navy considers Electric Boat to be not entitled to a contract adjustment for these problems, there is no question that the company will eventually submit a large omnibus claim in one form or another in an effort to get the Navy to underwrite Electric Boat's own financial problems. No doubt delay and disruption will constitute a large portion of such a claim. In past claims the difference between the amount the contractor could attribute to matters alleged to be Government responsible and the total amount claimed was frequently attributed to delay and disruption.

9. The Ship Acquisition Contract Administration Manual (SACAM) presently sets forth guidelines for analyzing delay and disruption. Under these guidelines the contractor is expected to provide facts and data upon which to substantiate his claim. The Navy Claims Settlement Board has followed this approach in analyzing Electric Boat's past claims.

10. With perhaps hundreds of millions of dollars at stake, as potentially is the case at Electric Boat, the Navy should not be lured away from evaluating delay and disruption claims on their individual merits. Were the Navy to adopt a formula approach along the lines the CNA study suggests, attempts to resolve delay and disruption claims would degenerate into unresolvable disputes over which equations, models, and assumptions most accurately simulate the particular ship construction process whenever the Government offer is less than the contractor wants. Consultants have developed models with widely varying results — all impressive in their apparent logic and mathematical sophistication, yet all dependent on highly subjective assumptions.

11. To administer its contracts properly, the Navy must strive for simplicity. The CNA proposal leads in the opposite direction. Those who administer contracts must be able to understand what it is they are doing. Rest assured that if mathematical models such as that proposed by CNA become the basis of contract payments, contractors will hire systems analysts to "out model" the Navy. No judicial forum could reasonably be expected to be able to deal effectively with the disputes that would inevitably arise.

12. Changes typically total about 5 percent of the price of a ship. They are an inevitable part of the shipbuilding business and shipbuilders are well aware of this. For the most part, shipbuilders price these contract changes as well as the contracts themselves using historical costs of prior ships. Cost estimates derived in this manner therefore have built into them the effects of delay and disruption incurred on prior work. To whatever target price is negotiated based on these estimates, the Navy typically agrees to absorb 80 percent or more on overruns subject to the limits of a ceiling price. In the TRIDENT and SSN 688 contracts, the so-called spread between target cost and ceiling price ranges from 30 to 52 percent of target cost. This spread provides a high degree of protection for errors in cost estimating or other risks. Further, the Navy recognizes those estimated costs of delay and disruption that the contractor can reasonably support. Thus the overall arrangement should satisfy any reasonable concern that the Navy is not fulfilling its obligation to equitably compensate its shipbuilders for the cost of changes.

13. Past experience with formula pricing shows, as the CNA report itself acknowledges, that these systems work only to the extent both parties stay satisfied with the results. The serious claims

problems however have arisen in an environment in which contractors were determined to hold out for more than the Navy concluded it owed. Thus the Navy would be better off to confine delay and disruption analysis to the specifics of the case rather than adopt a cumbersome system which works only to the extent the shipbuilder is satisfied with the results. If adopted, the CNA recommendations would result in another one-way street. In cases where the contractor is willing to accept the formula results, the formula would be the basis for rationalizing the Government payments. However, in cases where the contractor is dissatisfied, he could disavow the system.

15. In essence, a simplistic solution is being proposed to a most difficult problem which has defied the efforts of many experienced and sophisticated people. Ever since conglomerates took over Naval shipbuilding they have been chiefly interested in maximizing their profits – regardless of the means to accomplish this aim. That is the crux of the problem. The solution to human greed cannot be found by means of a mathematical model.

16. In summary I recommend against CNO issuance or endorsement of this study. I further recommend that the Navy cancel other efforts which have been underway for many years to derive a simple formula approach for pricing delay and disruption. As explained above, shipbuilders have ample protection under the present contract procedures for recognition and payment of legitimate delay and disruption they can reasonably substantiate.

H. G. Rickover

Copy to:
Assistant Secretary of the Navy
 (Manpower, Reserve Affairs, &
 Logistics)
General Counsel of the Navy
Chief of Naval Material
Commander, Naval Sea Systems Command
Deputy Commander for Contracts,
 Naval Sea Systems Command
Counsel, Naval Sea Systems Command

DEPARTMENT OF THE NAVY
THE ASSISTANT SECRETARY OF THE NAVY
(SHIPBUILDING AND LOGISTICS)
WASHINGTON, D.C. 20360

4 December 1981

MEMORANDUM FOR THE CHIEF OF NAVAL MATERIAL

SUBJ: CNA Study "Disruption Costs in Navy Shipbuilding Programs"; Release Disposition

Ref: (a) NAVSEA-08 memorandum dated 3 December 1981; same subject

I have reviewed reference (a) and its enclosure and agree completely with the conclusion that the application of statistically based, mathematical models for contract change negotiation and adjudication is flawed in concept and would be highly contentious in application. Any possible practical, beneficial use would be totally compromised for the reasons indicated in enclosure (1) to reference (a).

At the same time, however, I am not certain that we have a good legal reason to deny release of the report. Unless the assumptions or the data used in model development and evaluation involves classified information, the subject matter itself would appear to be benign from the standpoint of national security. I suggest that we receive a brief on this report by the study contractor and his Navy sponsor and review the security implications after that time.

Nevertheless, I am interested as to the rationale allegedly used by CNO last year in allowing a study, the conclusions of which apparently were not acceptable to Navy, to be promulgated by a Navy contractor because of the "independence" of that contractor. All our contractors are supposed to perform as independent entities. Indeed, my years of experience as a study contractor with many public and private agencies without exception have been based on the premise that:

o The client who pays for the study either owns the report outright or at least has proprietary rights to its results.

o If the client does not accept the results of the study, he can so indicate (indeed with private clients, he often also doesn't pay!)

Since the report has already been released within the Government, it is possible that it must be now legally releasable to the public. Release would clearly be required under a Freedom of Information Act request. Nevertheless, I see no reason why we cannot require that the frontpiece of the document clearly stipulate any and all our reservations with regard to concept and content -- perhaps headed in 3" block characters "DISAPPROVED." Under such circumstances CNA might very well have second thoughts about releasing the report.

George

GEORGE A. SAWYER

Copy to:
COMNAVSEASYSCOM
→ NAVSEA-08

DEPARTMENT OF THE NAVY
NAVAL SEA SYSTEMS COMMAND
WASHINGTON, D.C. 20362

IN REPLY REFER TO
7 January 1982

MEMORANDUM FOR THE COMMANDER, NAVAL SEA SYSTEMS COMMAND

Subj: Arrangements for Post Shakedown Availability of USS OHIO (SSBN 726)

Ref: (a) EBDIV ltr Ser 140/12-141-T.D.47 dtd 21 Dec 1981

1. I understand that the Naval Sea Systems Command and Electric Boat are scheduled to sign the contract today for construction of the ninth TRIDENT submarine. Before signing this contract there is an important issue the Navy needs to settle with Electric Boat to avoid a recurrence of claims from that shipyard. This concerns arrangements for the April 1982 Post Shakedown Availability (PSA) of the USS OHIO - the lead TRIDENT submarine.

2. As you will recall, during the last year of OHIO's construction Electric Boat contended that even minor work items performed prior to delivery would lead to delay and disruption of OHIO - and consequent claims. Electric Boat has continually pressed the Navy to defer as much work as possible for accomplishment after delivery during the PSA. The Navy has cooperated with Electric Boat, and only directed accomplishment of essential work items on the basis that the remaining work would be accomplished during the PSA.

3. The issue of the OHIO PSA, however, has been in controversy for the past year. Electric Boat has attempted to severely limit the work to be accomplished during the PSA, and has suggested that a PSA work load which uses a high proportion of critical trades would cause delay and disruption to other work in the shipyard. I understand that despite extensive efforts by the Supervisor and NAVSEA personnel there is still no agreement that Electric Boat will accept and perform the work in the OHIO the Navy needs to accomplish. By reference (a) Electric Boat provided a "planned manning" chart for the OHIO PSA which identifies the manpower, by trade, the company would commit to the PSA. Reference (a) further advised the Supervisor that Electric Boat's execution of a contract modification to perform the PSA was conditioned on agreement that any work would be cancelled "which Electric Boat Division considers exceeds the sixty (60) day duration and/or which causes a disproportionate concentration of trade allocation..."

4. Electric Boat officials know it is not practicable for the Navy, at this late date, to accomplish the OHIO PSA at any other shipyard. It appears, therefore, that the company may be trying to set up the OHIO PSA as the basis for a delay claim on Navy shipbuilding

contracts. This is of particular concern since, in its efforts to reap the public relations benefits of delivering seven (7) ships in 1981, Electric Boat undermanned later ships.

5. While senior Navy officials have been complimenting Electric Boat on finally delivering, in 1981, seven (7) ships originally scheduled to be delivered years earlier, the Navy should not lose sight of the fact that Electric Boat has a tradition of passing off to the Navy through claims problems created by itself. The company's position with respect to the PSA for the OHIO has the very earmarks of another claims situation.

6. It is wrong to award another TRIDENT contract to Electric Boat when the company has not yet agreed to perform the required PSA work in the first TRIDENT submarine. The Navy would thereby lose an opportunity to protect itself against a problem Electric Boat is creating for future use against the Navy.

7. Based on the above, I recommend that before the Navy signs the contract for the ninth TRIDENT the Navy should obtain an agreement that Electric Boat will provide adequate resources to perform all the required OHIO PSA work without impact on other contracts. Please advise me of the action you intend to take with regard to this matter.

H. G. Rickover
H. G. Rickover

Copy to:
Assistant Secretary of the Navy
  (Shipbuilding and Logistics)
Chief of Naval Operations
Chief of Naval Material
TRIDENT Systems Project Office (PM 2)
Vice Commander, Naval Sea Systems Command
Deputy Commander for Contracts, Naval
  Sea Systems Command
Counsel, Naval Sea Systems Command
TRIDENT Submarine Ship Acquisition Project (PMS 396)

○